

STATE AND MUNICIPAL DEBT: THE COMING CRISIS? PART II

HEARING

BEFORE THE
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES
AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS
OF THE

COMMITTEE ON OVERSIGHT
AND GOVERNMENT REFORM
HOUSE OF REPRESENTATIVES

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STATE AND MUNICIPAL DEBT: THE COMING CRISIS? PART II

TUESDAY, MARCH 15, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND
BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 1:42 p.m. in room 2154, Rayburn House Office Building, Hon. Patrick T. McHenry (chairman of the subcommittee) presiding.

Present: Representatives McHenry, Amash, Buerkle, Meehan, Walsh, Guinta, Quigley, Maloney, Welch, and Speier.

Also present: Representatives Issa, and Cummings.

Staff present: Robert Borden, general counsel; Sharon Casey, senior assistant clerk; Steve Castor, chief counsel, investigations; Benjamin Stroud Cole, policy advisor and investigative analyst; John Cuaderes, deputy staff director; Gwen D'Luzansky, assistant clerk; Adam P. Fromm, director of Member liaison and floor operations; Tyler Grimm and Ryan M. Hambleton, professional staff members; Peter G. Haller, senior counsel; Christopher Hixon, majority deputy chief counsel, oversight; Justin LoFranco, press assistant; Mark D. Marin, senior professional staff member; Becca Watkins, deputy press secretary; Jason Powell and Steven Rangel, minority senior counsels; Cecelia Thomas, minority counsel/deputy clerk; and Davida Walsh, minority counsel.

Mr. MCHENRY. The committee will come to order.

This is a meeting of the TARP, Financial Services and Bailouts of Public and Private Programs subcommittee. The hearing is entitled State and Municipal Debt: The Coming Crisis?

At the beginning of this hearing, as I do with all subcommittee hearings, I read the mission statement of the Oversight and Government Reform Committee. So that is what I will do now.

The Oversight Committee mission statement: We exist to secure two fundamental principles. First, Americans have a right to know that the money Washington takes from them is well spent. And second, Americans deserve an efficient, effective government that works for them.

Our duty on the Oversight and Government Reform Committee is to protect these rights. Our solemn responsibility is to hold government accountable to taxpayers because taxpayers have a right to know what they get from their government.

We will work tirelessly in partnership with citizen watchdogs to deliver the facts to the American people and bring genuine reform

to the Federal bureaucracy. This is the mission statement of the Oversight and Government Reform Committee.

With that, I will recognize myself for 5 minutes for an opening statement.

This hearing is the second installment of the subcommittee's efforts to examine the causes and severity of fiscal problems facing States and municipalities. Today will explore the magnitude of the growing budget liability of State and municipalities, and its origins. From years of unwise fiscal policy to reckless management and collusion between elected officials and the public sector unions, a crisis has emerged as a great expense to the American people.

It also has an impact on our markets. It also has an impact on people's savings, especially for retirement.

Leading economists have already labeled 2012 as the States' most difficult budget year on record. Forty-four States and the District of Columbia are now projecting aggregate budget shortfalls totaling \$125 billion this year alone. It only gets worse each year.

Even more threatening is the \$3.2 trillion in unfunded State pension liabilities, and another \$383 billion liability for local governments.

To be sure, the budget crunch is closely associated with the larger economic stresses facing the country. But years of unchecked spending and overly generous benefits have taken their toll. There are \$3 trillion in municipal bonds outstanding across the country. Many State and municipal governments face the real possibility of defaulting on their debt.

Ultimately, this hearing is about two things. First, what is the real debt burden facing States and municipalities? Second, what must be done to mitigate the immediate crisis and put these governments back on solvent fiscal paths?

But let me restate for the record what I said in Part I of this hearing, back on February 9th: the era of the bailout is over. Let me repeat: taxpayer bailouts are not on the table. The past 2½ years of wasteful spending and irresponsible policy under the guise of economic stimulus and emergency economic stabilization have emptied the Treasury of every thin penny. And even if Washington had more money to spread around, a bailout would only serve to delay the coming day of judgment, pushing on our children and grandchildren the burden of paying for our irresponsible spending.

There must be other options, and this series of hearings is about assessing those options, first understanding the problem, and assessing our options to move forward.

Some States are making bold efforts at reform. In 2009, for instance, the State of Utah experienced such massive losses due to the market collapse that taxpayer contributions to workers pensions would have to rise to \$420 million annually to keep them afloat. Senator Dan Liljenquist, however, successfully championed a plan for reform that will allow the State to remain solvent and enjoy greater budget flexibility. Senator Liljenquist, thank you for being here today. I look forward to your comments.

At the executive level, Governors like Chris Christie of New Jersey and John Kasich of Ohio have begun to push piece by piece legislation to reform their pension plans gradually. While still others, like the State of Wisconsin, for instance, have become the proving

grounds for the future. Last week, Governor Scott Walker made good on his promise to voters to overhaul the entire structure of public sector unions in the State. That is a bit of controversy, of course, even the President has commented upon that. Governor Walker's legislation has met with great resistance, but fomenting political chaos will not help to serve or fix this fiscal crisis.

The question before us today may require careful, sober consideration. And it is critical and critically important that Congress examine the State and municipal fiscal crisis and judiciously evaluate reasonable policy options. Today's witnesses are all experts in that field, and the subcommittee will give them an attentive ear.

With that, I yield 5 minutes to the ranking member, Mr. Quigley of Illinois.

[The prepared statement of Hon. Patrick T. McHenry follows:]

Rep. Patrick McHenry, Chairman
Subcommittee on TARP, Financial Services and Bailouts of
Public and Private Program

Draft Opening Statement
“State and Municipal Debt: The Coming Crisis? Part II”
March 15, 2011

This hearing is the second installment of this subcommittee’s effort to examine the causes and the severity of fiscal problems facing states and municipalities. Today, we will explore the magnitude of the growing budget liability and its origins. From years of unwise fiscal policy to reckless management and collusion between elected officials and the public sector unions, the crisis has emerged at great expense to American taxpayers.

Leading economists have already labeled 2012 as “the states’ most difficult budget year on record.” Forty-four states and the District of Columbia are now projecting aggregate budget shortfalls totaling \$125 billion this year alone, and it only gets worse each year. Even more threatening is the \$3.2 trillion unfunded state pension liability and another \$383 billion liability for local governments.

To be sure, the budget crunch is closely associated with the larger economic stresses facing the country. But years of unchecked spending and beyond generous benefits have also taken their toll. There are \$3 trillion in municipal bonds outstanding across the country, and many state and municipal governments face the real possibility of defaulting on their debt.

Ultimately, this hearing is about two things. First, what is the real debt burden facing the states and municipalities? And second, what must be done to mitigate the immediate crisis and put these governments back on a solvent fiscal trajectory. But let me restate for the record what I said in Part One of this hearing back on February 9th.

The era of the bailout is over. Let me repeat, taxpayer bailouts are not on the table. The past 2½ years of wasteful spending and irresponsible policy under the guise of economic stimulus and emergency economic stabilization have emptied the Treasury of every thin penny. And even if Washington had more money to spread around, a bailout would only serve to delay the coming Day of Judgment, pushing to our children and grandchildren the burden of paying for our irresponsible spending.

There must be other options, and this series of hearings is about assessing those options.

Some states are making bold efforts at reform. In 2009, for instance, the State of Utah experienced such massive losses due to the market collapse that taxpayer contributions to government workers' pensions would have to rise by \$420 million annually to keep them afloat. State Senator Dan Liljenquist, however, successfully championed a plan for reform that will allow the state to remain solvent and enjoy greater budget flexibility. I look forward to hearing from Senator Liljenquist discuss his plan today.

At the executive level, Governors like Chris Christie in New Jersey and John Kasich in Ohio have begun to push piece-by-piece legislation to reform their pension plans gradually. While still others, like the State of Wisconsin for instance, have become the proving ground for the future. Last week, Governor Scott Walker made good on his promise to Wisconsin voters to overhaul the entire structure of public sector unions in the state.

Governor Walker's legislation was met with great resistance, but fomenting political chaos will not help solve this crisis.

The questions before us today require careful, sober consideration. It is critically important for Congress to examine the state and municipal fiscal crisis and to judiciously evaluate reasonable policy options. Today's witnesses are all experts in this field, and this Subcommittee will give them our attentive ear.

Thank you and I yield to the Ranking Member for his opening statement.

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Mr. QUIGLEY. Thank you, Mr. Chairman.

Before I begin, I ask unanimous consent to have a statement from the National Education Association be entered into the record.

Mr. MCHENRY. Without objection.

[The information referred to follows:]

Statement of the National Education Association
 To the Oversight and Government Reform Committee
 Subcommittee on TARP and Financial Services
 Hearing on
 “State and Municipal Debt: The Coming Crisis, Part II”
 March 15, 2011

 The National Education Association, representing 3.2 million public educators working in classrooms across the country, respectfully submits this statement for the record in conjunction with the above-referenced hearing. We thank the Subcommittee for the opportunity to provide these comments.

NEA strongly believes that all working Americans – public and private sector employees alike – deserve a secure retirement. Part of the American dream is to be able to retire with dignity and security after a lifetime of hard work. Yet, increasingly, more Americans are facing unattractive choices – having to work indefinitely (if they can find a job and are physically able), living in poverty, or being forced to look for assistance from family or government. Without adequate retirement income, older Americans will lack the resources that allow them to live independently, afford health care, and contribute to the economy.

We are deeply concerned by rhetoric and actions being taken at the state level that place the blame for state budget crises on public employees and public sector pensions. We believe the focus on pensions as a solution for budget shortfalls is misplaced, and will only undermine the secure retirement earned by public employees and further jeopardize economic recovery.

Pension Plans Not in Crisis

Public pension plans are not in crisis. Participants do not all retire on the same day and draw down their pensions. On the contrary, pensions are funded and paid out over decades. Pension liabilities are being misused by opponents of public pension plans to confuse the long-term nature of pension obligations with short-term debt obligations. They have created the misguided impression that drastic and immediate measures are needed to avoid an imminent fiscal meltdown.

The truth, however, is that public employee retirement systems have substantial assets. There is currently \$2.7 trillion already set aside in pension trusts for current and future retirees. Boston College researchers project that if the assets in state and local pension plans were frozen tomorrow and there was no more growth in investment returns, there would still be enough money in state plans to pay benefits for years to come. Public pension funds are sustainable and have sufficient assets to pay benefits now and into the future.

Like all investors, public employee pension plans were hit by the downturn in the stock market, but they are durable and efficient and over time, they can recover their losses. Most state and local government employee retirement systems have substantial assets; those that are underfunded are taking steps to strengthen funding. More state and local governments enacted significant modifications to improve the long-term sustainability of their retirement plans in 2010 than in any other year in recent history. It is not the fault of public employees that some states did not make adequate pension contributions in the past or that the practices of Wall Street caused the recession and the loss of jobs and billions of dollars in investments. Nevertheless, in the past few years, nearly two-thirds of states have made changes to benefit levels, contribution rate structures, or both, and many local governments have made similar fixes to their plans. Most importantly, only a year after suffering record investment losses, many of the nation's largest public pension plans are reporting double-digit percentage gains for the budget year that ended in June 2010.

It is important to note that the majority of public employee pension benefits are funded by returns on fund investments—about 75 percent. Although the amount contributed by employers to fund benefits often varies from year to year, the average amount is currently about 9.5 percent, while employees contribute about 6 percent of their salary. Public employees share in the financing of their pension, which in many cases is in lieu of Social Security. The vast majority of public employees are required to contribute a portion of their wages—typically five to ten percent—to their state or local pension, and these contribution rates are being raised in many state and local governments.

Economic Contributions of Public Employee Pensions

Public employee pension checks represent a vital, continuous source of spending in every state, city, and community across America. Some 7.3 million retired Americans receive a monthly pension check, which translates into enormous economic benefits. Spending by retirees provides stability to national, state, and local economies, especially during tough economic times.

Pension dollars help the economy of every jurisdiction. Public employees live in every city and county in the nation; more than 90 percent retire in the same jurisdiction where they worked. The over \$175 billion in annual benefit distributions from pension trusts are a critical source of economic stimulus to communities throughout the nation, and act as an economic stabilizer in difficult financial times. Recent studies have documented public retirement system pension distributions generate over \$29 billion in federal tax revenue and more than \$21 billion in annual state and local government tax revenue, create 2.5 million jobs, and have a total economic impact of more than \$358 billion.

Great Public Schools and Retirement Security

Protecting the economic future of public school employees is not only the right thing to do, it is the smart thing to do - it ensures a high quality workforce and a healthy economy. But, in order to retain the most accomplished individuals in our classrooms, we need to take care of them now and in the future.

This country demands a lot from its teachers and others who work in public schools and rightly so. Education professionals enter and stay in the profession, not for the money, but because they are dedicated to helping their students learn and prepare for the future. They don't expect to be wealthy, but they do expect and deserve a decent retirement.

Defined benefit plans are a proven tool for retaining accomplished public sector professionals. They provide public sector workers with a more secure and predictable pension than other types of retirement plans. Yet, plan benefits for education employees are modest. The pension of a full career education employee replaces only a portion of the salary earned while working, and educators' salaries are so low that their pension provides only a modest living in retirement. The average retirement benefit for public employees is \$22,600 and for many of them, including nearly half of all teachers and over two-thirds of firefighters and public safety officers, it is in lieu of Social Security. State and local salaries on which these pensions are based are lower than those for private sector employees with comparable education and work experience, even when benefits are included.

Conclusion

The real key to viable employee pension plans is to ensure that our economy continues to recuperate in a healthy and responsible way. Instead of looking at taking away retirement security from public employees and demanding unneeded action to change their benefits, we should protect them while working to restore retirement security for all American workers.

Sources:

NASRA Issue Brief: State and Local Government Spending on Public Employee Retirement Systems
 The Funding of State and Local Pensions, Center for State and Local Government Excellence
 Pensions and Retirement Plan Enactments in 2010 State Legislatures, National Conference of State Legislatures
 The Wage Penalty for State and Local Government Employees, Center for Economic and Policy Research
 Out of Balance? Comparing Public and Private Sector Compensation Over 20 Years, Center for State and Local Government Excellence/National Institute on Retirement Security
 Pensionomics: Measuring the Economic Impact of State and Local Pension Plans, National Institute on Retirement Security

Mr. QUIGLEY. Thank you.

Mr. Chairman, I would like to thank you for convening today's hearing, the second hearing on State and municipal debt. I would also like to thank our five witnesses for contributing their time and expertise.

In fiscal year 2012, 44 States are projected to have a budget deficit of at least 5 percent. Although troubling, this is a short-term fiscal problem that has more to do with the current economic downturn than with underfunded pension programs. Once the economy gets going, State revenues will go up and budget deficits will shrink.

In the long term, however, we have an accounting problem unique to six or eight States, among them Illinois, California, Ohio, and New Jersey. For years, under both Republican and Democratic leadership, these States have grossly underfunded their pension programs.

No one has to tell me there is a problem. I am from Illinois. Illinois is one of the worst examples, with \$162 billion unfunded liability. Its pension system is less than 50 percent underfunded. This level of under funding is reflected in Illinois' bond rating. In the last 5 years, its bond rating has taken a nose dive. Before it raised taxes, an outcome nobody wanted, its bonds were considered only slight less risky than Iraq's.

Its bond rating is still poor. And that means it is much more expensive for Illinois to borrow money. According to Laurence Msall of the Civic Federation, bad bond ratings were costing Illinois taxpayers \$551 million extra per year in interest payments. States like these need to take common sense steps to shore up their pension systems.

Reform is important not only to protect taxpayers, but also to protect the beneficiaries of public sector pensions. These pension systems provide retirement security for millions of Government workers. We have a responsibility to ensure that we are not short-changing them.

Pension reform should restore long-term solvency to pension systems, so that workers can depend on a steady retirement income. We can keep defined benefit plans, while taking reasonable steps like increasing worker contributions and realigning retirement age, COLAs, and term of service. In some States like Illinois, pension reform will have to go farther than in others.

What we have to avoid is a one size fits all approach that doesn't distinguish between the bad apples and the good. And we also have to remember that the onus must be on State governments to reform themselves. One model for troubled States might be the recent series of pension reforms in Massachusetts. Under Governor Deval Patrick, Massachusetts has passed several pension reform packages. Just earlier this year, in January, the Governor proposed eight reforms that would improve the long-term sustainability of the State's pension system. Officials have estimated that these reforms will save Massachusetts billions of dollars over the next 30 years. They are also an important step toward a higher bond rating and lower borrowing costs.

On February 8th, the Bond Buyer reported that Standard and Poor's revised Massachusetts' outlook to positive from stable, based

on strong management practices. Of course, every State and municipality is different, and pension reform would have to be tailored to each specific situation. Still, the Massachusetts example demonstrates that pension reform can be achieved that not only increases bond ratings but decreases borrowing costs, and that also protects workers and guarantees them a steady retirement income.

I thank the chairman and I yield back.

Mr. MCHENRY. I thank the ranking member, and I certainly appreciate the panel being here today.

Members will have 7 days to submit opening statements for the record. We will recognize the panel now. I will introduce the whole panel, then we will begin with you, Senator Liljenquist, to give your opening statement.

The Honorable Dan Liljenquist is a member of the Utah State Senate. Mr. Robert Kurtter—I sorry, I am bouncing around—is the managing director for U.S. State and Regional Ratings at Moody's. Mr. Dean Baker is co-director of the Center for Economic and Policy Research. Thank you, Mr. Baker, Dr. Baker, I am sorry. Ms. Robin Prunty is the Team Leader for State Ratings at Standard and Poor's. And Mr. Andrew Biggs is a resident scholar at the American Enterprise Institute for Public Policy Research.

It is the policy of the committee that all witnesses be sworn in before they testify. So if you will please rise and raise your right hands.

[Witnesses sworn.]

Mr. MCHENRY. You may be seated. Let the record reflect that all the witnesses answered in the affirmative.

Now, in order for us to have time for discussion, we do have votes on the floor in less than an hour, so if you could keep your comments to 5 minutes. The clock will register for you, as you can see, with 1 minute remaining it moves from green to yellow. That means hurry on up and finish. And any time that you don't use is really a gift. So if you can summarize your statements, we will also let you offer your full statements for the record.

With that, Senator Liljenquist, you are recognized for 5 minutes.

STATEMENTS OF HON. DANIEL LILJENQUIST, UTAH STATE SENATOR; ROBIN PRUNTY, MANAGING DIRECTOR, RATINGS SERVICES, STANDARD AND POOR'S FINANCIAL SERVICES LLC; DEAN BAKER, CO-DIRECTOR, CENTER FOR ECONOMIC AND POLICY RESEARCH; ROBERT KURTTER, MANAGING DIRECTOR, MOODY'S INVESTORS SERVICE; AND ANDREW G. BIGGS, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

STATEMENT OF HON. DANIEL LILJENQUIST

Mr. LILJENQUIST. Thank you, Chairman McHenry, Ranking Member Quigley and members of the committee. It is an honor to be with you today.

If there is an upside of an economic downturn, it is that taxpayers throughout the United States are waking up to the massive liabilities incurred by State and local governments. In particular, financial commitments made to public employees are driving policy debates throughout this country. Defined benefit pensions are at

the heart of these policy debates, as policymakers wrestle with the approximately \$3 trillion unfunded pension liabilities.

For years, public employee pension plans have largely been exempted from taxpayer scrutiny because of the long-term nature of pension commitments and the assumption that today's market losses will be made up by tomorrow's gains. However, the market crash of 2008 revealed just how much market risk taxpayers are bearing to guarantee pension benefits for public employees.

Utah's pension system is a case in point. If I might, I would like to spend a couple of minutes discussing the situation in Utah. Going into 2008, Utah's public employees pension systems were over 100 percent funded. Utah has always paid the full required actuarial contribution to its pension systems, and has not raised retirement benefits for 20 years. Utah's retirement system has been and still is recognized as one of the best-run pension systems in the country.

However, market losses in 2008 blew a 30 percent hole in Utah's pension fund, opening up a \$6½ billion unfunded liability. To put this number in perspective for the State of Utah, our constitutional debt limit is set at 1½ percent the total assessed value of real property in the State. That value is currently \$4.4 billion, and we borrowed \$3.3 billion of that \$4.4 billion or approximately 75 percent.

Adding Utah's official debt to Utah's newly recognized unfunded pension liabilities, Utah's total debt is \$9.8 billion, which is 223 percent of Utah's constitutional debt limit.

In the fall of 2009, Utah's Joint Retirement Independent Entity sub-appropriations committee, of which I am the Senate co-chair, requested an in-depth actuarial review of Utah's pension liabilities. For the first time in our State, we asked our actuaries, instead of looking in the rearview mirror, to look forward for 40 years and assess a variety of scenarios to give us a better understanding of where we are going. The report highlighted some troubling facts.

First, we realized that Utah, and I would say any other State, if you look forward, cannot grow its way out of these pension problems. We would have to average, in Utah, 13 percent returns year over year for 20 years to grow out of the 2008 losses. If Utah's pension system averages its assumed 7 3/4 rate of return, and we do nothing else, Utah's pension system will be bankrupt by approximately 2040.

Second, we realize Utah must dramatically increase contributions to the pension system required to compensate for the 2008 losses. These contributions will increase and continue to increase over the coming years, and stay there for an amortization period, which is 25 years. Our total contributions will equate to approximately 10 percent of Utah's general and education funds for 25 years to pay off 1 year's worth of losses.

Finally, the study from our actuaries showed that Utah cannot absorb another year like 2008. For example, if we hit a 6 percent return over the next 25 years, we are bankrupt now as a State and don't know it. Because we are hoping that we can get the market returns we need to meet the commitments we have made to our employees.

Last year, the Utah legislature acted aggressively to cap its existing pension liabilities. We closed our defined benefit pension plans to new enrollees, creating a new retirement system for new public employees hired after July 1, 2011. The crux of our pension reforms are that the State will no longer have an open-ended guarantee to its public employees. Instead, we are saying affirmatively we will put a certain amount toward retirement, and that is what you get.

Employees have the option to choose between a 401(k) style plan and also a defined benefit pension hybrid plan. But they are on the hook for the market risk.

It is our hope in the State of Utah, as we have tried to manage all our liabilities and risks, that other States will follow suit. It is now time to act and make sure we are containing these liabilities, so we can move forward as a State and as a country. Thank you.

[The prepared statement of Mr. Liljenquist follows:]

Testimony of Utah State Senator Dan Liljenquist:

House Committee on Oversight and Government Reform

Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

March 15, 2010

It is an honor for me to appear before The Committee on Oversight and Government Reform, Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs to discuss State and Municipal Debt: The Coming Crisis Part II.

If there is an upside of an economic downturn it is that taxpayers throughout the United States are waking up to the massive liabilities incurred by State and Local governments. In particular, financial commitments made to public employees are driving policy debates in statehouses throughout the country, from New Jersey to Wisconsin to California. Defined benefit pensions are at the heart of these debates as policy makers wrestle with the approximately \$3 Trillion in unfunded pension liabilities.

For years, public employee pension plans have been largely exempted from taxpayer scrutiny because of the long-term nature of pension commitments and the assumption that today's market losses will be made up by tomorrow's gains. However, the market crash of 2008 revealed just how much market risk taxpayers are bearing to guarantee pension benefits for public employees. Utah's pension system is a case in point.

Going into 2008, Utah's public employee pension systems were over 100% funded. Utah has always paid the full required actuarial contribution to its pension systems, and has not raised retirement benefits for over 20 years. Utah's Retirement System had been, and still is, recognized as one of the best-run pension systems in the country.

Market losses in 2008 blew a 30% hole in Utah's pension fund, opening up \$6.5 Billion in unfunded pension liabilities. To put this number in perspective, Utah's constitutional debt limit is 1.5% of the total assessed value of property in the state and currently stands at \$4.4 Billion. Utah's official debt currently stands at \$3.3 Billion, or 75% of Utah's debt limit. Adding Utah's official debt to Utah's newly recognized unfunded pension liabilities, Utah's total debt is \$9.8 Billion, 223% of Utah's constitutional debt limit.

In the fall of 2009, Utah's Joint Retirement & Independent Entities Sub-Appropriations committee, of which I am the Senate co-chair, requested an in-depth actuarial review of Utah's pension liabilities. Utah's retirement actuaries, Gabriel Roeder Smith, delivered an extensive report to the committee, projecting the full impact of the 2008 market losses on Utah's pension system. The report Utah's pension actuaries delivered to the committee revealed several troubling facts.

First, Utah cannot grow its way out of the problem. Utah would have to average 13% pension fund returns every year for 20 years to grow out of the 2008 losses. If Utah's

pension system averages its assumed 7.75% annual rate of return, Utah's pension system will be bankrupt by 2040.

Second, Utah must dramatically increase contributions to the pension system to compensate for the 2008 losses. Utah's actuaries project that Actuarial Required Contributions will have to be increased by 75%, and remain at historically unprecedented levels for 25 years to pay off the 2008 losses. This 75% increase in required contributions equates to nearly 10% of Utah's general and education funds for 25 years.

Finally, Utah the actuarial study by Gabriel Roeder Smith demonstrated that Utah cannot afford to absorb another year like 2008. If, for example, Utah averages 6% market returns over the next 25 years (instead of the assumed 7.75% return) Utah is bankrupt now and just does not know it. A 6% return over the next 25 years would open up pension liabilities of over \$20 Billion.

The bottom line of this analysis was that Utah was and is bearing far more risk with its defined benefit pension systems than it ever anticipated. The only thing that can bankrupt the State of Utah is if its pension system misses its assumed rates of return on its pension portfolio.

Last year, the Utah Legislature acted aggressively to cap its existing pension liabilities. Utah closed its defined benefit pension plans to new enrollees, creating a new retirement system for new employees hired after July 1, 2011. Under Utah's new retirement system, public employees will receive a defined employer contribution towards retirement. New public employees will be able to choose to between (1) a 401(k) style program, or (2) a Hybrid pension program (where they may pool market risk with other employees). Regardless of the program employees choose, Utah will only contribute at set amount towards retirement. Utah's recent pension reforms will, over time, reduce and eliminate Utah's pension related bankruptcy risk. This is a big win for Utah taxpayers.

Pension reform, including efforts to move to defined employer contributions, will continue to dominate the headlines over the next several years. Those States who choose to tackle pension reform by capping defined benefit systems and migrating towards defined contribution systems will find that taxpayers are with them. Those States who choose not to do so will continue to subject their taxpayers to the whims of an unpredictable market. It is my hope that other States will look to Utah for an example on pension reform. It is also my hope that this Committee and this Congress will encourage states to reform their pension systems by refusing to bail out irresponsible states.

Mr. MCHENRY. Ms. Prunty.

STATEMENT OF ROBIN PRUNTY

Ms. PRUNTY. Thank you, Mr. Chairman, Mr. Ranking Member, members of the committee. Good afternoon. My name is Robin Prunty, and I am a managing director in Standard and Poor's Ratings Services business. I am an analytic manager in charge of the State ratings group.

Standard and Poor's is a credit rating agency and as such conducts analysis and forms forward-looking opinions about the creditworthiness of debt and debt issuers, including among others, States and municipalities. I am pleased to appear before you today.

Standard and Poor's believes that the difficulties faced by States and municipalities will give rise to very difficult budget and policy decisions, but not default for our rated universe in the overwhelming majority of cases. This is because State and municipal debt obligations are secured either by a specific pledge of the Government's full taxing authority or dedicated taxes, user revenues or fees. And there is often a priority status for debt relative to other obligations.

Because States and in many cases local governments are required to balance their budgets rather than finance budget deficits solely through debt issuance, they are annually making choices to align revenues and expenditures. These actions, along with the Federal stimulus funding, contributed to relative credit stability for most U.S. public finance issuers. While credit downgrades have increased over the last 2 years, and we expect there could be further credit deterioration in 2011, in the majority of cases, we believe that general obligation and other types of direct debts of State and local governments that we rate will continue to be retired as scheduled.

Over the past 25 years, there have been 42 defaults for non-housing issues in U.S. public finance at Standard and Poor's. There has been observed default by a State in more than 100 years. Although the number of defaults has been, relatively speaking, low, we do believe the securities issued by rated governments can still face meaningful default risks.

Because of the slow progress of the recovery from the recession, S&P believes that the continued flat or slow revenue growth transfers State and local governments may add to strain on budgets and overall liquidity, especially in the short term, as Federal stimulus funds end. In addition, we believe that pensions and other post-employment benefit obligations represent material long-term risks to governments, and have long been factored into our criteria for rating State and local governments. Recent investment performance of the assets in most pension trust fund is well below historic trends and negative in many cases, which has contributed to weakened pension funding levels. Governments that are not funding their annual required contributions risk the most significant changes in their budget capacity in the future.

Such concerns have given rise to pension reform movements in certain States, and we expect that this will continue. While we believe that liabilities to public employees represent genuine long-term pressures on government credit quality, they generally are

not immediately competing for most governments' capacity to fund their debt service or meet other priority payment obligations.

In general, we believe that the worst-case scenarios regarding pensions will likely occur only if governments are unable or unwilling to use their powers of adjustment. Notwithstanding the difficult policy choices facing State and local governments, S&P continues to expect that most issuers that we rate will continue to retain their strong capacity and willingness to meet their debt obligations. Moreover, there is little incentive for them to allow their debt obligations to default. This is in part because we believe that a defaulted debt service payment would likely result in a loss of access to the capital markets, which has been a significant source of funding for capital and infrastructure projects for both State and local governments.

We have observed that governments have made many improvements to their budget structure, reserve policies and debt management during prior periods of budget stress, which in our view has generally enhanced their ability to manage through downturns. Reconciliation of structural revenue and expenditure misalignments may not be achieved in one fiscal year, but reform efforts are underway for many governments. We expect that this will continue through 2011.

Effective financial management will be key to addressing these challenges. And governments have strong powers of adjustment. If governments do not manage or make adjustments, and instead rely heavily on debt and other one-time solutions in the hope that economic growth will balance their budgets, we believe that they could be setting themselves up for greater hardship in the near term.

Throughout difficult economic periods, including during and after this most recent recession, we have generally seen on the part of governments what we consider to be a very strong commitment to their debt obligations, which for us has been an important credit consideration over time. While there are vulnerabilities in the public finance sector, our expectation is that the threat of default is generally not widespread among State and municipal issuers that we rate.

I thank you very much for the opportunity to participate in this hearing, and would be happy to answer questions that you may have.

[The prepared statement of Ms. Prunty follows:]

**TESTIMONY OF ROBIN PRUNTY
MANAGING DIRECTOR, RATINGS SERVICES,
STANDARD & POOR'S FINANCIAL SERVICES LLC
BEFORE
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC
AND PRIVATE PROGRAMS
UNITED STATES HOUSE OF REPRESENTATIVES
MARCH 15, 2011**

Mr. Chairman, Mr. Ranking Member, Members of the Committee, good afternoon. My name is Robin Prunty. I serve as a managing director in Standard & Poor's Ratings Services business ("S&P"), and I am an Analytical Manager for the State Ratings Group at S&P. S&P is a credit rating agency, and, as such, conducts analysis and forms forward-looking opinions about the creditworthiness of debt and debt issuers, including, among others, states and municipalities. Our core mission is to provide the markets with quality, independent analysis, and we publish our opinions broadly to the world. I am pleased to appear before you today, and intend to cover two main topics: (i) the significant financial and budget challenges faced by states and municipalities, and (ii) our views on the general credit outlook for states and municipalities we rate.

Background on the Municipal Market and Credit Quality

The diversity of the municipal bond market defies easy generalization. There are a wide variety of issuers ranging from fire districts to state governments. In addition, there are many different security pledges supporting debt issued by state and local governments. We rate over sixty different security types ranging from the more common general obligation pledge to narrowly based revenue or tax pledges. S&P maintains ratings on approximately 17,500 distinct state and municipal issuers, but these ratings do not encompass the entire municipal market. There are nearly 90,000 local government entities in the U.S. and many are authorized to issue debt. Municipal issuers tend to be self-selecting: that is, municipal issuers of lower credit quality tend not to seek credit ratings. Correspondingly, the universe of rated municipalities is, as a general proposition, more creditworthy and generally less likely to default than non-rated issuers.

In light of this, in assessing the difficulties faced by states and municipalities in the aftermath of the recent economic recession, it is important to distinguish the nature of the challenges they face. S&P believes the difficulties faced by states and municipalities will give rise to tough policy decisions, but not defaults for our rated universe in the overwhelming majority of cases. This is because debt obligations are secured either by a specific pledge of the government's full taxing authority or dedicated taxes, user revenues or fees, and there is often a priority status for debt relative to other obligations. We have generally seen a very strong commitment by governments to their debt obligations over time, despite difficult economic cycles. Because states and in many cases local governments, are required to balance their budgets rather than finance budget deficits through debt issuance, they are annually making choices to align revenues and expenditures. Since the onset of the recession, we have seen many U.S. states and local governments making difficult policy and budget choices in an effort to balance their budgets. These actions, along with federal stimulus funding, contributed to relative credit stability for most U.S. public finance issuers. While credit downgrades have increased over the past two years and we expect there could be further credit deterioration in 2011, in the majority of cases, we believe general obligation and other types of direct debts of state and local governments we rate will continue to be retired as scheduled. Over the past twenty five years, there have been 42 defaults for non-housing issues in U.S. Public Finance at S&P; 40 were rated non-investment grade immediately before the default ("U.S. Public Finance Defaults and Rating Transition Data: 2010 Update"). There has been one observed default by a state in more than one hundred years. Although the number of defaults has been, relatively speaking, low, we do believe securities issued by rated municipalities can still face meaningful default risk.

Difficulties faced by States and Municipalities

Because of the slow progress of recovery from the recession, S&P believes that continued flat or slow revenue growth trends for state and local governments may add to fiscal strain on budgets and liquidity, especially in the short term. We expect the difficult budget environment to continue for many rated state and municipal issuers in 2011.

The severity and duration of the recent recession suggests to us that economic recovery could continue to be slow. Standard & Poor's forecasts U.S. economic growth of 3.1% during 2011, below the average 5.0% GDP gain observed during the last eight economic recoveries from recession dating to the early 1960s (see "Economic Research: U.S. Risks To The Forecast: Ring Out The Old Recession, Bring In The... ?" published on Dec. 21, 2010; "U.S. Economic Forecast: A More Prosperous 2011?" published on Jan. 5, 2011; and "U.S. Economic Forecast: Pouring Water On Troubled Oil" published on March 8, 2011, available on S&P's Global Credit Portal). Reduced spending, be it from lower incomes or from saving more, translates to lower overall demand, employment, and tax revenues.

We believe the housing market is likely to continue to provide an additional source of economic pressure. With the lag between market prices for real estate and the assessment process relevant to property tax revenues, in our view, home price trends offer further evidence of a relatively long and slow recovery for state and local government finances.

Even if a more robust economic recovery were to take hold, we expect that state and local government revenues may continue to demonstrate a muted response to the recovery owing to the end of federal stimulus funding and the expiration of previously adopted temporary tax increases. This is in addition to the typical historical lag between economic growth and

improved state and local government tax revenues. Revenue recovery is underway for most states, but remains below pre-recession levels for most. According to the U.S. Census Bureau, third quarter state tax receipts increased 4.8% (\$7.6 billion) and combined state and local tax revenues grew 5.2% (\$284.3 billion) compared to the same period last year. Year-to-date total state tax revenue, which was up 1.26% through September 2010, posted the first annual increase since 2008.

In addition to the effects of the recession and the subsequent slow recovery, we believe that pensions and other post-employment benefit obligations represent material long-term risks to governments and have long been factored into our criteria for rating state and local governments. Recent investment performance of the assets in most pension trust funds are well below historic trends, and negative in many cases, calling into question certain assumed rates of return on these assets. As voters face economic pressures and market losses in their retirement accounts, taxpayers' and legislators' willingness to guarantee pension benefits for public employees may waiver. Actuarial projections of future contributions necessary to fund the benefits or to restore funding levels to pension funds depict potential tradeoffs that taxpayers -- and voters -- may be unwilling to accept. Governments that are not funding their annual required contributions risk the most significant changes in budget capacity.

Such concerns have given rise to pension reform movements in certain states. Some states are re-examining the fundamental nature of the governments' obligations, while others are focused on containing the growth of existing liabilities by reducing benefits levels for all newly hired government employees. While we believe that liabilities to public employees present genuine long-term pressures on government credit quality, they generally are not immediately

competing for most governments' capacity to fund their debt service or meet their other priority payment obligations. History strongly suggests that the majority of governments can and will make the needed adjustments. Prior to accounting changes in the 1980's that required governments to report pension liabilities in their financial statements, there were limited assets to fund liabilities and many changes and reforms were made to public plans to improve funding levels. In general, we believe worst-case scenarios regarding pensions will likely occur only if governments are unable or unwilling to use their powers of adjustment.

Impact of Budget Gaps

If the economic recovery staggers in combination with revenue reductions, we think that fiscal strain can evolve into outright budget crises for particular locales that have low reserves and thin financial liquidity.

Most U.S. states and many local governments are required by law to balance their annual budgets, which can necessitate difficult service cuts or tax increases when resources are insufficient to fund baseline spending trends. If this occurs, policymakers may face difficult decisions representing zero-sum tradeoffs for stakeholders, many of whom may have contradictory objectives. We have seen that cuts to certain government services in favor of others can be contentious, and ongoing high rates of unemployment place pressure on states' social service infrastructure networks. Notwithstanding the difficult policy choices facing state and local governments, S&P continues to expect that most issuers we rate will retain strong or even very strong capacity and willingness to meet their debt obligations. Moreover, there is little incentive for them to allow their debt obligations to default. This is in part because the funds

required for debt service are relatively low; the median debt service among U.S. states was 3.0% of total expenditures for 2009. Foregoing or canceling debt payments would therefore yield relatively little in terms of budget savings. Beyond achieving relatively little savings, we believe that a defaulted debt service payment would likely result in a loss of access to the capital markets, which has been a significant source of funding for capital and infrastructure projects for state and local governments.

For some governments, capital market access can also be critical for funding operations. Many governments' cash receipts do not align with their disbursement schedules. Governments often manage this mismatch by issuing short-term notes to smooth their annual cash flow cycles. For these governments there is a strong incentive to retain the creditworthiness necessary to sell cash flow notes in order to sustain even the most basic of functions.

We have observed that governments have made many improvements to budget structure, reserve policies, and debt management during prior periods of budget stress, which, in our view, have generally enhanced their ability to manage through downturns. Some of the states with the most severe projected budget gaps, notably California and Illinois, have structural budget reform on their agendas for the upcoming legislative sessions. Reconciliation of structural revenue and spending misalignments may not be achieved in one fiscal year, but initial indications in some states suggest that the discussion may continue in earnest during 2011. The new law requiring Illinois to produce public multi-year financial forecasts is an example of the reform efforts.

Outlook for Municipal Markets

We anticipate greater market volatility in the prices for municipal securities in 2011. In our view, rating downgrades, instances of severe fiscal problems and a generally softer environment for municipal credit could well occur. But we also believe that fundamental credit performance of states and municipalities we rate -- as measured by default rates relative to debt outstanding in the market -- will likely remain mostly stable with the possibility for a modest up-tick, in light of the difficult economic and revenue environment.

State and local governments could be faced with the prospect of selling bonds to a narrower investor base in 2011 compared to 2009 and 2010 due to the expiration of the Build America Bond ("BAB") program, which had temporarily reduced their cost of borrowing. Without that program, we expect issuers to revert to selling traditional tax-exempt debt, which tends to appeal only to investors subject to U.S. federal income taxes. We believe an increased supply of tax-exempt bonds in the market could result in higher interest rates for issuers in need of financing.

Although noteworthy for the municipal market, expiration of the BAB program has little direct bearing on the credit quality of most issuers in our view. By allowing issuers to sell federally subsidized bonds to taxable investors, the BAB program broadened the municipal investor base. If the ability to issue taxable debt siphoned the overall supply of debt away from the tax-exempt market, it likely benefited issuers in the form of lower tax-exempt yields during the last two years.

Government Response Is Key

The recent recession revealed common challenges faced by many state and local governments, and we believe such governments will be facing the lagging effects for at least the next couple of years. Effective financial management will be key and governments have strong powers of adjustment, which in our view means they generally have an ability to withstand what we consider to be extreme stress scenarios that could otherwise lead to default. However, we believe that if governments consistently rely heavily on debt and other one-time solutions and continue to ignore or postpone service provision, revenue enhancement, pension and other post-employment benefit funding needs in the hope that economic growth will balance their budgets, they could be setting themselves up for greater hardship in the near future.

While we expect there may be an increased number of public finance rating downgrades in 2011, we believe the majority of state and local government issuers we rate will likely retain solidly medium-to-high investment grade ratings. Throughout difficult economic periods, including during and after this most recent recession, we have generally seen on the part of state and local governments what we consider to be a very strong commitment to their debt obligations, which for us has been an important credit consideration over time.

Although we view budgets as inherently political documents, governments' management of cash and their commitment to debt obligations has remained largely apolitical in our view. If we were to observe a change to this, the credit implications could be significant. While there are vulnerabilities in the public finance sector, our expectation based on our analysis is that the threat of default is generally not widespread among the state and municipal issuers we rate. Moreover, whatever budget or political crises the recession has caused, and whatever doubts may be held

about the wisdom of public policy directions or the priorities of the public sector, we expect the overwhelming majority of rated U.S. state and municipal governments will survive the recession without defaulting.

Conclusion

I thank you for the opportunity to participate in this hearing, and I would be happy to answer any questions you may have.

Mr. MCHENRY. Thank you, Ms. Prunty. That was probably the most amazing use of time. Well done, thank you.
Dr. Baker.

STATEMENT OF DEAN BAKER

Mr. BAKER. Thank you, Chairman McHenry and Ranking Member Quigley. I want to thank in particular Representative Quigley. I am also from Illinois, and my mother is one of those public employees who is dependent on the pensions there. So I appreciate your concern.

I want to make three main points in my comments today. First off, that the financial strain facing State and local governments first and foremost originates in Washington, or perhaps I should say Wall Street. It is a problem of the economy, and that is where most of the difficulties stem from. Second, the problems that our pension funds face are manageable. And the third point is that the pension fund accounting is, for the most part, reasonable, that they are looking at expected returns on their pension funds. Requiring pension funds to use a risk-free rate of return in assessing their funds could lead to higher costs and possibly ending defined benefit plans altogether, which I would argue would mean higher costs for taxpayers.

First point, the fact that the problems originate in Washington should be fairly straightforward. We are 3 years, 2 months into a recession. The unemployment rate is still 4½ percentage points higher than it was prior to the downturn. If we compare that to the last serious recession, 1981, 1982, we already were back a the pre-recession level of unemployment. It is reasonable to expect State and local governments to prepare for downturns, but this is an extraordinary one, without precedence. This was due to mismanagement here in Washington, at the Federal Reserve Board, irresponsibility on Wall Street. This is not your run of the mill recession.

And just an idea of how much difference that makes, we are currently 6 percent below potential GDP. If we assume that State revenues were 6 percent higher, a good first approximation, most of these States would have no problems at all balancing their budget. In the case of Wisconsin, which of course has been in the news lately, they would have \$4 billion in additional revenue over the 2-year horizon, fully making up their shortfall, before even taking into account the savings on expenditures for programs like unemployment insurance, TANF and other expenditures that have increased during the downturn.

So this is first and foremost a problem that originates in Washington. Not to say that all governments are responsible, but certainly the problems were enormously worsened by the severity of the downturn.

The second point, oftentimes we scare people by using big numbers. The pension liabilities, however, estimated, are very big numbers. But if we calculate them relative to the size of the future economy, over a 30-year period, the normal horizon, we are looking at a shortfall that by my calculations is a little more than two-tenths of a percent of GDP. That is hardly trivial, but if we compare that, say, to the increase in defense spending from 2000 to

2011, that was 1.7 percentage points of GDP. So the amount of additional revenue, whether through tax increases or reduction in other spending, is about one-eighth as much as we found to increase our defense spending, defense budget, between 2000 and the present. Not to say that is trivial, but that it is very much a manageable sum.

The last point I will make is that I would say that the pension funds are using appropriate accounting. They are using expected values. And I will say that I have been a critic of their accounting in years past, in the 1990's and the 2000's when you had very high price to earnings ratios. They were making assumptions about future stock returns that were clearly unrealistic. I said that quite openly at the time.

Now that you have had a big fall in the stock market, going forward, the given price to earnings ratios and given growth projections from the Congressional Budget Office and other major forecasters, their assumptions on rates of return are very realistic.

The alternative, if we are to insist the pension funds use a risk-free rate of return, we would have two stories we could tell. One is that they continue to invest in equities, but they assume a risk-free rate of return. This would, in effect, require pre-funding. This would be very perverse policy, it would mean more taxes or less spending in the current to have savings in the future. We might think that prudent in some sense, but I don't know of anyone who has recommended pre-funding schools, pre-funding fire departments. That is not ordinarily the way we expect our governments to function.

The alternative is to say, OK, they would just invest in bonds and get the lower risk-free rate of return. If we did that, pension fund would be more costly to State and local governments, which would mean a higher burden to taxpayers.

The final possibility is we could end up eliminating them altogether, which as we know some States have done, some local governments have done. This again is a cost to taxpayers, if we think this through carefully. Defined benefit pensions are something that workers value greatly.

The fact is that State and local governments can endure timing risks with the stock market, because they are essentially infinitely live entities. Individuals, of course, have finite lives. For individuals, it is a very, very big risk. By virtue of taking that risk, we are able to get either better employees for the same wages, or the same employees for lower wages. That is a benefit that workers get in exchange for other compensation.

If State and local governments no longer take advantage of their indifference to risk, they end up losing that benefit. That will cost taxpayers more money. Thank you.

[The prepared statement of Mr. Baker follows:]

**Testimony of Dean Baker
before the
House Oversight and Government Reform Committee's Subcommittee on TARP,
Financial Services and Bailouts of Public and Private Programs**

March 15, 2011

Thank you, Chairman McHenry and Ranking Member Quigley, for inviting me to testify before the subcommittee and to share my views on the debt problem facing state and local governments. I will make three main points in my comments:

- 1) The financial crisis facing state and local governments is primarily a problem created in Washington. Had it not been for the failed monetary and regulatory policies carried through by the Federal Reserve Board and other regulatory agencies, few state and local governments would be facing serious financial problems today;
- 2) The shortfalls facing many state and local pension funds are in most cases manageable; and
- 3) The valuation method used by most pension funds is appropriate. The alternative method of assuming a risk-free rate of return on pension assets -- even those held in equities -- is likely to lead to the end of defined benefit pension funds. This will increase the cost to taxpayers of hiring public sector workers.

I will address these issues in turn.

The first point is very important for how members of Congress view the fiscal problems facing state and local governments. This crisis was not due to an epidemic of fiscal irresponsibility infecting elected officials across the country. Rather, it was attributable to an economic collapse of a magnitude that the United States had not seen since the Great Depression.

As a result of this collapse, output has been roughly 6 percent below its potential since the first months of 2009. The Congressional Budget Office and other forecasters project that the economy will remain far below its potential level of output for 4-5 more years. This fall in output led to plunging revenue collection. At the same time, the sustained rise in unemployment increased demand for a wide range of services provided by state and local government, such as unemployment insurance, Medicaid and other publicly financed health programs, and TANF.

As a first approximation, it is reasonable to assume that state and local government revenue moves in step with GDP, although the revenue falloff was steeper in this

downturn than the drop in GDP, because the collapse of the bubbles in residential and non-residential real estate caused property taxes to fall by more than the decline in GDP. If revenue had maintained its trend growth path, states would be in a very different financial situation today. For example, the State of Wisconsin would have more than \$4 billion in revenue in its 2-year budget. This would be more than sufficient to eliminate its projected deficit, even before considering the savings on the spending side that would result from a more normal rate of unemployment.

While recessions are endemic to a capitalist economy, this downturn is truly extraordinary. Three years and two months after the beginning of the prior two recessions, the unemployment rate stood 1.6 percentage points above its pre-recession level. By comparison, the February unemployment rate is 4.4 percentage points above the pre-recession level. The Congressional Budget Office does not project that the economy will be within 1.6 percentage points of its pre-recession level until 2015 --more than seven years after the recession started in December 2007.

Allowing the housing bubble to grow unchecked was a blunder of monumental proportions, but this was an error made by the Fed and other regulatory bodies, not state and local officials. It was possible to recognize a dangerous bubble and the inevitable consequences of its collapse as early as 2002.¹ House prices had grown far out of line with their historic pattern. There was no corresponding rise in rents, indicating that the rise in house prices could not be explained by the fundamentals of the housing market. Similarly, the fact that the vacancy rate was already at a record high in 2002 should have been a clear sign that a shortage of housing was not explanation for the unprecedented increase in nationwide house prices.

In spite of the evidence of a serious bubble in the housing market, then Federal Reserve Board Chairman Alan Greenspan insisted that there was nothing unusual in the housing market. The current Federal Reserve Board Chairman Ben Bernanke, who was a Federal Reserve Board governor at the time, openly agreed with Greenspan's assessment. The overwhelming majority of the country's leading economists also agreed with the view that everything was fine in the housing market even as the housing bubble grew to ever more dangerous levels and housing became more heavily leveraged. In fact, the 2005 meeting of the world's central bankers in Jackson Hole, Wyoming was a Greenspan retrospective in which participants celebrated the "Great Moderation."

This background is important. Any elected official who saw the trouble brewing on the horizon and tried to prepare for it would not only have had to fend off demands from constituents for lower taxes and better services, they also would have been forced to take on virtually the entire economics establishment. It is not surprising that few state and local officials were up to this challenge.

¹ The evidence for a housing bubble is described in Baker, D., 2002. "The Run-Up in House Prices: Is It Real or Is It Another Bubble?" Washington, DC: Center for Economic and Policy Research, available at [http://www.cepr.net/index.php?option=com_content&view=article&id=405].

If the fiscal crisis facing state and local governments had its origins in Washington, it is reasonable to expect that the solution also lies in Washington. This could mean aid to state and local governments, which Congress has already provided to some extent, but more importantly Congress and the Fed could act more aggressively to bring the economy back towards its potential level of output. In order for state and local governments to balance their budgets at a point where the economy is operating well below its potential it is necessary to impose higher tax rates than would otherwise be necessary and/or to cut public services precisely at the time when they are most needed. In addition to the direct harm caused by these steps, both tax increases and spending cuts will further depress demand, thereby slowing growth and raising unemployment.

If the economy remains severely depressed for a long period of time, then state and local governments will be correspondingly strained. However, if the economy were to rebound and return to near potential levels of output, then the budget problems facing most state and local governments will be manageable. This is seen clearly with the pension shortfalls that have been highlighted in recent news reports.

There is a range of estimates of shortfalls using the current methodology, but most put the size of the shortfalls in the range of \$600 billion to \$1 trillion. While these numbers sound large, it is important to put the shortfall in context. These shortfalls need to be made up over the funding horizon for pension funds, which is usually around 30 years. The shortfalls are between 0.2-0.3 percent of the projected GDP over this period. It would come to around 1.2 to 1.8 percent of state revenue over this period. While this is hardly a trivial sum, it is difficult to see this as an insurmountable burden for states to overcome. By comparison, the increase in annual spending on defense from 2000 to the present was equal to 1.7 percentage points of GDP.

It is also worth remembering that most of the pension shortfalls are attributable to the plunge in the stock market following the collapse of the housing bubble. Since the market has since regained much of its value, it is likely that much of the reported shortfall will disappear in future reports simply as a result of the rise in the stock market.

It is worth noting that there are pension funds that have been seriously mismanaged and under-funded. Efforts to restore these plans to proper funding may impose substantial costs, however such funds are the exception. Most state and local funds are close enough to being fully funded that the gaps can be closed without imposing major burdens on state and local governments.

Finally, there is a serious dispute as to whether pension funds are using the proper discount rate for their liabilities when they assume the expected return on pensions that are heavily invested in equities, rather than applying a risk-free rate of return as the proper discount rate for their liabilities. I would argue that, given current price to earnings ratios in the market, state and local pension funds are being prudent to use a discount rate that is based on the expected return to their assets. Assuming the risk-free rate would likely lead to the elimination of traditional pensions and impose unnecessary costs on taxpayers.

State and local governments are fundamentally different from individual investors. Individual investors must be concerned that the market could be depressed at the time when they retire or have other reason to need their savings. For that reason, they do substantially discount the risk associated with the volatility of the stock market.

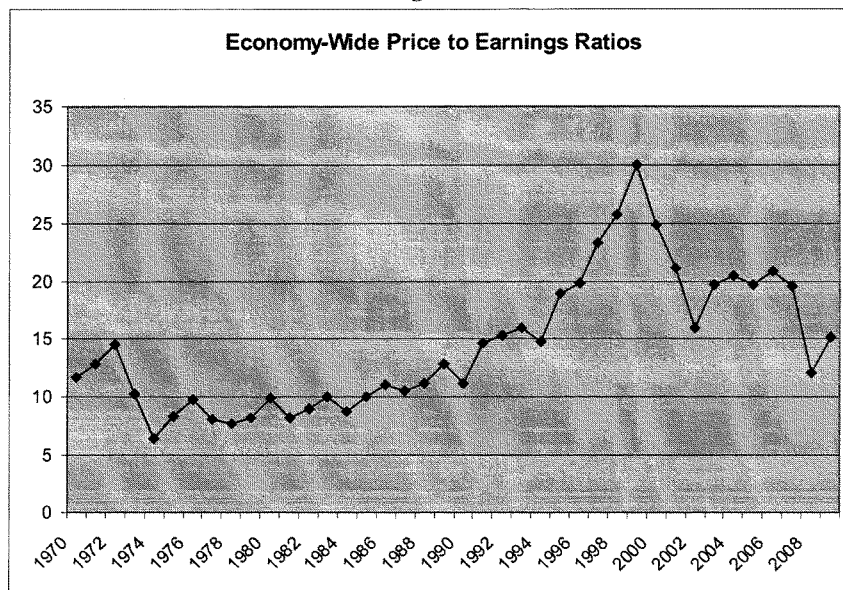
The logic of using expected values, rather than the risk-free rate, stems from the fact that state and local governments are better able to bear risk than individual investors. If the market experiences a downturn, as is now the case, state and local pension funds can easily cover their pension obligations from the current funding flows combined with the sale of non-equity assets. It would take a truly extraordinary set of events (one much worse than the downturn that we are currently experiencing) to force pension funds to liquidate large amounts of their equity investments in a down market.

It is important to note that the expected return on stocks over a long period must be adjusted depending on the current price-to-earnings ratios and the projected growth rate of the economy and profits. As I previously argued, pension funds were irresponsible in the late 1990s and in much of the last decade in assuming a 10 percent nominal rate of return on the portion of their assets invested in equities.² This rate of return was not plausible at the time. However, with the economy-wide ratio of stock prices to after-tax earnings now around 15, an assumption of a 10 percent nominal return is again plausible. Figure 1 below shows the ratio of stock prices to after-tax profits since 1970.³

² Weller, Christian and Dean Baker. 2005. "Smoothing the Waves of the Perfect Storm: Changes in Pension Funding Rules Could Reduce Cyclical Underfunding." Labor and Employment Relations Series, Proceedings of the 57th Annual Meeting, available at <http://www.press.uillinois.edu/journals/lera/proceedings2005/weller1.html>.

³ The numerator comes from the Federal Reserve Board's Flow of Funds, Table L.213, Line 23. The denominator is obtained by taking the average share of profits in GDP over the prior decade (NIPA Table 1.12 Line 15 divided by Table 1.15 line 1, multiplied by the most recent year's GDP).

Figure 1



Source: Federal Reserve Board, Bureau of Economic Analysis and author's calculations.

While the 8 percent nominal rate of return on pension fund assets is consistent with the expected value of the assets held by these funds, as can be easily shown, it is worth considering the implication of assuming the risk-free rate of return on pension fund assets. If pension funds continue to hold equities, but assume a risk-free rate of return, then they would be required to heavily increase their level of funding for the next several years until they were fully funded using the risk-free rate of return as the discount rate.

However, we would expect that the assets held by the fund would provide a substantially higher rate of return than the risk-free rate being assumed for assessing funding levels. This would mean that once the fund had reached full funding levels assuming a risk-free rate of return, much smaller contributions would be needed in future years, since the excess returns from equities could provide much or all of the income necessary to meet funding targets.

In effect, current taxpayers would be paying more so that future taxpayers would pay less. This would be equivalent to pre-funding the fire department or the schools. Few policy experts would advocate this course of action.

A second problem arises if pensions use the risk-free rate for accounting purposes, but continue to invest in equities. The return on equities is more volatile than the return on government bonds. If pension fund managers are required to effectively assume a risk free rate of return, regardless of which asset the fund holds, they will feel pressure to shift

pension holdings into assets that are less risky. Why would a pension fund manager want to take the risk of having an under-funded pension, if they will not get credit for the higher expected return associated with holding equities?

Of course, if pensions were invested entirely in bonds, then they would provide a lower return. The result would be that taxpayers would be forced to pay higher taxes to provide the same level of benefits to public sector employees. It is difficult to see how this could be a desirable outcome.

Finally, if pensions could only provide the return available on risk free assets, then there would be less benefit from having a defined benefit pension. This could lead many state and local governments to eliminate defined benefit pensions altogether. Such a step would also impose costs on taxpayers.

Defined benefit pensions are clearly valued by workers, since they would prefer not to take the risk of investing for their retirement on their own. If governmental units were to no longer offer this benefit, then economic theory implies that they would either have to pay higher wages to get workers of the same quality or would end up with lower quality workers if they continued to offer the same level of compensation, but without a defined benefit pension.⁴

Defined benefit pensions are a way in which both workers and taxpayers could gain by taking advantage of the fact that governments are better able to deal with the risk of market fluctuations than individuals. This is why both conservative and liberal governors, mayors, and legislators have supported defined benefit pension plans for public employees for decades. When state and local governments scrap defined benefit pension plans, they are effectively throwing money away. This is not good policy.

⁴ There is considerable research showing that adjusting for education and experience, public sector workers receive somewhat lower compensation than their private sector counterparts. See Keefe, J. 2010. "Debunking the Myth of the Overcompensated Public Employee," Washington, DC: Economic Policy Institute [available at http://www.epi.org/publications/entry/debunking_the_myth_of_the_overcompensated_public_employee] and Schmitt, J., 2010. "The Wage Penalty for State and Local Government Employees," Washington, DC: Center for Economic and Policy Research [available at <http://www.cepr.net/index.php/publications/reports/wage-penalty-state-local-gov-employees/>].

Mr. MCHENRY. Thank you, Dr. Baker.
Mr. Kurtter.

STATEMENT OF ROBERT KURTTER

Mr. KURTTER. Thank you. Good afternoon, Mr. Chairman, Congressman Quigley and members of the subcommittee.

My name is Robert Kurtter. I am a managing director in the U.S. public finance group at Moody's Investors Service. I want to thank you for inviting Moody's to share our views as part of today's hearings.

My comments will focus on the credit risk of public finance bonds that are rated by Moody's. A significant number of public finance bonds are not rated by Moody's or any other rating agencies. Because unrated issuers and bonds may have quite different risk characteristics than rated ones, my comments should not be generalized to the entire universe of public finance bonds.

I also want to be clear that Moody's opinions in this sector speak only to the likelihood that a Government-issued bond is likely to be paid in full and on a timely basis. While we take into account all of an issuer's major financial obligations, we do so in order to assess the likelihood that an issuer can and is willing to meet its payment obligations to bond investors. This means that when we use the term default, we are referring specifically to the failure to make payments to bondholders, and not a failure to fulfill any other obligations a State or local government may have, such as utility payments, salaries due to employees or pension liabilities.

I will turn now to our views on the sector. All of us here today know that State and local governments are experiencing unprecedented financial strain. This is reflected in the negative outlooks Moody's has had on all major subsectors in this market. For State and local governments, our negative views are driven by four main factors.

First, the overall economy is still fragile, even though it is recovering. Second, State and local governments are facing increased liabilities, such as pension and health care costs. Many commentators have recently focused on pension liabilities. Moody's has long factored these liabilities into our analysis and opinions. Growing unfunded pension obligations are creating challenges for these issuers. And we are monitoring the situation closely. We have taken and will continue to take rating actions where we believe an issuer's credit profile warrants it.

Third, lingering fiscal pressures have required State and local governments to make severe budget cuts, use budget reserves and pursue other non-recurring solutions to solve their budget gaps. And finally, revenue sources have strained due to persistent high unemployment, sagging real estate prices, which lead to drags on taxes.

Let me focus now specifically on the condition of the U.S. States. Most States are facing challenges with respect to both their liabilities and their revenues. The recovery is still fragile, unemployment is very high, and it is uncertain when sustained revenue growth will take hold. That said, Moody's does not see bondholder debt as a source of credit strain for most States. This is because

annual bond debt service costs remain a relatively small share of overall expenditures.

In addition, most States do not face refinancing or material roll-over risks. We believe that we could see a few more States turn to deficit financings to fund operating expenses, or restructurings to produce budget savings in 2011. But we expect those States to be the exception rather than the rule. For these reasons, and because of the strong incentives they have to pay their bond debt, we believe it is very unlikely that any States will default on their bond obligations in the next 12 to 18 months.

In the local Government sector rated by Moody's, we see unprecedented financial strain for the reasons I mentioned earlier. Further, the States can shift some costs to the local government level, which is likely to exacerbate the challenges there. However, we also expect that a majority of the individual local governments will make the tough decisions and the budget cuts needed to continue to make timely payments on their bonds.

We do not expect widespread defaults by rated State and local governments. However, there have been situations in the past where the risk of default seemed imminent, even though it was ultimately averted. We saw this, for example, in Harrisburg, Pennsylvania. We expect there will be some additional cases of severe credit stress going forward.

In summary, there is substantial credit pressure on the U.S. public finance sector today. Over the next 12 to 18 months, we believe it is unlikely that any State will default on its obligations to bond investors. We believe the increase in bond defaults among local governments will be relatively small.

Thank you again for inviting me to testify on this important matter. I look forward to answering your questions.

[The prepared statement of Mr. Kurtter follows:]

**Testimony of Robert Kurtter
Managing Director, U.S. Public Finance
Moody's Investors Service**

**Before the
United States House of Representatives
Oversight Subcommittee on TARP,
Financial Services and Bailouts of Public and Private Programs**

Hearing on State and Municipal Debt

I. Introduction

Good afternoon Mr. Chairman, Congressman Quigley and members of the Subcommittee. My name is Robert Kurtter, and I'm a Managing Director in the U.S. Public Finance Group at Moody's Investors Service ("Moody's"). Thank you for inviting Moody's to participate in today's hearing and share our views on the creditworthiness of state and local government bonds as part of the Subcommittee's inquiry into the financial situation of these entities.

In my testimony, I will explain what Moody's opinions on U.S. public finance bonds address and the key factors we consider in our credit analysis before turning to our current outlook on state and local government issuers. As part of that discussion, I will outline the assumptions that underpin our views on the U.S. public finance market and describe how we have taken and continue to take pension liabilities into account. At the outset, however, I would like to highlight the following:

- The U.S. public finance sector encompasses a large and very diverse universe of issuers.
- Different types of issuers face different pressures and have different tools to deal with the challenges they may face.
- Issuers in this sector are experiencing severe stress from the worst recession since the Great Depression.
- While many states and local governments are facing revenue and spending challenges, we believe it is very unlikely that any states will default on their bonds in the next 12-18 months and we expect only a relatively small increase in bond defaults by Moody's-rated local governments. This is because state and local governments have very strong incentives to meet their bond payment obligations.

I also want to emphasize that there are a significant number of unrated U.S. public finance bonds. Therefore, my comments should not be generalized to the entire universe of public finance bonds because, historically, unrated issuers and bonds have demonstrated greater levels of credit risk and may continue to have quite different risk characteristics in the future.

II. WHAT MOODY'S OPINIONS ADDRESS – AND WHAT THEY DO NOT

Next I would like to explain what Moody's opinions on the U.S. public finance market address – and what they do not address. There has been a lot of attention paid recently to the debt levels of states and local governments. The term "debt" can refer to many things. When Moody's uses the word "debt", we are referring specifically to "bond debt". We are not referring to any other obligations of the government, such as utility payments, salaries due to employees or pension liabilities. Our opinions speak only to the likelihood that a government-issued bond is likely to be paid in full on a timely basis, according to the contractual terms of that bond. This is what bond investors want to know. Therefore, when we use the term "default", we are referring specifically to the failure to make payments to bondholders. We do not rate and are not referring to the default on any other type of obligation to any other person or entity.

Similarly, the term "credit risk" can mean different things to different people. When Moody's uses the term "credit risk", we are referring to the risk that an issuer will not pay the obligations due on its bonds when those obligations come due. As I explain below, we take into account all of an issuer's major financial obligations as part of our analysis so that we can assess both the issuer's ability and its willingness to meet its bond payment obligations.

We're market observers and intend for our opinions to promote dialogue and debate among market participants about the relative credit risk of bonds issued in different regions and by different types of issuers. If people choose to consider our opinions, we expect them to use those opinions to supplement, and not replace, their own credit analysis.

III. KEY FACTORS IN OUR ANALYSIS

A. Overview

Against that backdrop, I will now provide an overview of the key factors we consider in our credit analysis of the U.S. public finance sector. By way of example, I will describe our analytical approach to the states. We focus on four broad factors:

1. *Economy*: We look at the breadth and diversity of the affected economy, including growth trends and comparative economic position to other, similar issuers.

2. *Finances:* We analyze information contained in financial statements as well as current budget information and compare this information to sector statistics for comparable issuers.
3. *Debt Ratios:* Debt ratios are calculated to adjust for size (debt per capita) and wealth (e.g., debt to personal income) and compared to sector medians.
4. *Governance/Management:* We assess the type of governance, including legal powers to manage finances and any legal constraints on taxing, borrowing or spending.

All of these factors are important to our assessment of the state's degree of financial flexibility to meet the specific obligations it faces with respect to its bonds. We also look at each factor's impact on the other factors.

B. States' Pension Liabilities

Many commentators have been focusing lately on states' pension liabilities. These liabilities have long been part of our analysis and are factored into our opinions. We recognize that growing, unfunded pension obligations are creating challenges that these issuers must address, and we are monitoring the situation closely. We have taken, and will continue to take, rating actions where we believe an issuer's credit profile warrants it.

From an analytical perspective, pensions are a type of long-term debt obligation, and therefore they are incorporated into our debt ratio analysis. Ongoing contributions to the pension fund also represent a current budget cost, which we consider in our analysis of an issuer's finances. And finally, our governance analysis incorporates the way a state responds to developments regarding its pension obligations.

There are three main reasons why unfunded pension liabilities have been growing in recent years. First, the economic downturn significantly diminished the value of pension funds' assets. Second, at the peak of the stock market, some states enhanced benefits and/or reduced employer contributions. Third, demographic factors, including the retirement of Baby Boom generation employees and the increasing life expectancy of beneficiaries, are adding to liabilities. These increasing liabilities have resulted in a situation where states have needed to increase their pension contributions at a time when declining revenues are also requiring them to impose budget cuts.

These developments have also drawn the public's attention to some other issues relating to pension finance. Specifically, many funds are not fully funded on an actuarial basis. Governmental accounting standards are different and give states more flexibility than corporations with respect to pension reporting.

Recently, because of market participants' interest in pension liabilities, we provided an additional perspective on these liabilities by publishing a report that combined unfunded pension liabilities with outstanding bond indebtedness. This combined debt and pension burden highlights different credit characteristics when compared to economic and revenue measures. For example, a comparison of combined liabilities to GDP, population and personal income shows the economic and demographic base that a state can draw on to meet its obligations over time. This approach also provides a basis for comparison with other sectors, such as hospitals and corporations.

IV. OUR OUTLOOK FOR THE STATES AND LOCAL GOVERNMENTS

There is unprecedented financial strain on the U.S. public finance sector and this is reflected in the negative outlooks we have on all major sub-sectors in this market. For state and local governments, we hold this view for various reasons, including:

- A recovering but still fragile overall economy;
- Increased liabilities, such as pension and healthcare costs;
- Lingering fiscal pressures, which have required severe budget cuts, use of reserves, and other nonrecurring solutions to solve budget gaps; and
- Strained revenue sources because of persistent high unemployment and sagging real estate prices, along with attendant drags on taxes.

A. Our Outlook for the States

There continue to be significant financial challenges for the states. While the fundamentals of the state sector remain strong (from the perspective of credit risks for bondholders), states face more credit pressure than they have in decades. While revenues have begun to stabilize, risks still remain in the economic outlook that could further strain state finances. For example, employment is slowly

improving but unemployment is still very high and risks remain relating to housing and oil prices. The recovery is still fragile and it is uncertain when sustained revenue growth will take hold. This means that in the near future, states probably will not be able to grow their way out of budget gaps. This might be the most difficult budget season of the downturn. For example, the end of most federal stimulus funding in June likely will require many states to make tough decisions as they adopt their fiscal 2012 and 2013 budgets, and this likely will cause reduced aid to local governments and public universities, as well as other significant cuts.

Future state budgets also will be increasingly challenged by rising pension and retiree health benefit costs. While many states have largely protected public services such as K-12 education and Medicaid from budget cuts to date, reductions in or other changes to those services are now more likely.

Despite these credit pressures, from the perspective of bondholders, bonds issued by the states continue to reflect a variety of credit strengths, including the following:

- State economies are broad-based and diverse.
- States have a variety of powerful fiscal management tools at their disposal, including balanced budget requirements, sovereign taxing authority to raise revenues, the ability to cut expenditures without reducing revenues (although large-scale state employee layoffs might depress economic growth), and the ability to cut or delay aid to local governments.
- Governments exist in perpetuity.
- Federal monetary policies benefit state economies.
- Bond debt, on its own or combined with unfunded pension liabilities, represents a relatively small proportion of states' total liabilities compared to other sectors, such as corporates. For example, debt owed to bondholders generally accounts for only 5-8% of state budgets and annual bond debt costs remain a relatively small share of expenditures. This means that governments have less incentive to default on these payments because non-payment would do little to solve major budget gaps.

- States have strong incentives to pay bond debt. General obligation bonds are backed by the state's full faith and credit pledge, which an investor can take to court to enforce. The states also are motivated to treat other bond debt the same way so that they can continue accessing the markets to finance initiatives such as the construction of schools, roads and hospitals. For the same reasons, in the extremely unlikely event of a state default on general obligation bonds or related debt, we expect that investors' rate of recovery on their bonds would be very high.

B. Our Outlook for the Local Government Sector

Our outlook for the local government sector remains negative for various reasons, including the following:

- *Ripple effect due to the states' fiscal problems:* States are cutting or delaying aid to local governments in significant numbers, transferring costs from themselves to their cities, counties and K-12 schools. Some states are also passing laws that limit the local government's ability to raise taxes.
- *Ramifications of the lag between house price declines and property tax assessments:* The main revenue source for most local governments is property taxes. For many local governments, property value assessments lag changes in house prices. Because of this timing lag, the revenue impact of the sharp decline in U.S. housing prices is only being felt severely now by many local governments. Furthermore, we expect that the taxable value of housing will continue to decline through the fall of 2011 before starting to show modest improvement.
- *Tougher budgetary choices:* Many expenditure cuts already have been made, leaving mostly reductions in services that will be felt by the public, including cuts to K-12 education and police and fire services. The growth rate of employee costs, such as pensions and health spending, will pose additional challenges when local government finances are already strained. Raising revenues through tax increases is unpopular. To avoid tax increases, some governments are expected to turn to asset sales.

C. Financial Stress Not Expected to Lead to Widespread Defaults on Rated Bonds

While states are facing a revenue and spending problem, Moody's does not see debt in the form of obligations to bondholders as the source of credit strain for most states. As noted above, annual bond debt costs remain a relatively small share of expenditures. In addition, most states do not face refinancing or material rollover risks. We could see a few more states turn to deficit financings to fund operating expenses, or restructurings to produce budget savings in 2011, but we expect those states to be the exception rather than the rule. For these reasons and because of the strong incentives states have to pay their bond debt, we do not expect any states to default on their bond obligations in the next twelve to eighteen months.

In the Moody's-rated local government sector, we expect a relatively small increase in defaults from historically low levels, but we do not expect a wave of defaults. One reason for the expected increase in bond defaults is that the states can reduce or delay their aid to local governments or cut programs so that local governments have to step in and fill the resulting funding gap. This is likely to exacerbate problems at the local government level. But we also expect that the majority of individual local governments will make the tough choices and painful budget cuts needed to continue making timely payments on their bonds. As a credit rating agency, we do not have views on which choices these issuers should make. Rather, we focus on whether the choices they make increase or decrease the likelihood that they will meet the contractual obligations under their bonds.

While we do not expect a wave of actual bond defaults by rated state and local governments, there have been situations in the past, for example in Harrisburg, Pennsylvania, where the risk of bond default seemed imminent but was averted. We expect there will likely continue to be selective instances of severe credit stress.

D. Assumptions

Moody's views on credit risk are predictions about the future and, as such, they are based on certain assumptions, or expectations, about what is likely (but not guaranteed) to happen. I have set out below a number of the assumptions we have incorporated into our outlook for the next twelve to eighteen months. We expect that:

- State and local governments will honor their contractual obligations to make bond payments because there are such strong incentives for them to do so.
- State and local governments will be able to continue accessing financial markets on roughly the same terms that are available to them now.
- State and local governments will continue to have sufficient budget flexibility, e.g., to cut costs and/or increase revenues, to meet the contractual obligations associated with their bonds.
- Bankruptcy laws will not change.
- The economic recovery will not be derailed by, for example, an oil price shock.

We recognize that a number of the assumptions above currently are the subject of debate. We constantly monitor the environment in which state and local governments operate, seeking information that is relevant to these assumptions. If at any time during our ongoing analysis, we were to begin seeing shifts that might call into question the appropriateness of these assumptions, we would reconsider those assumptions and, if we believe the facts and circumstances warranted it, revise and communicate our views to the market.

Thank you again for inviting me to testify on this important matter, and I look forward to answering your questions.

Mr. MCHENRY. Thank you, Mr. Kurtter.
Dr. Biggs.

STATEMENT OF ANDREW G. BIGGS

Mr. BIGGS. Chairman McHenry, Ranking Member Quigley and members of the committee, thank you for offering me the opportunity to testify with regard to State and municipal finances and the role that public pension financing may play.

It is my hope that State and local finances will avoid a severe disruption. Like a plane buffeted by turbulence, they will survive so long as they had sufficient altitude before the event. My greatest concern is not so much for this recession as the next one, which inevitably will come. If we enter that one in precarious financial position, State and local governments may not have sufficient room to maneuver.

The rising costs of public sector pensions, while not the main driver of State and local financial problems, have gained increasing prominence in recent months. My work on public pension financing argues that if we wish to strengthen State and local government finances, we need an accurate assessment of the size of pension liabilities and the steps that will and won't help the governments reduce them. Current pension accounting methods unequivocally fail on this front.

To be clear, the so-called market valuation critique of pension financing is not a criticism of the average returns that plans project for their investments. It does not say, for instance, that pension funds will yield 7 percent on average rather than the 8 percent average they claim. Rather, it says that because this 8 percent is a risky return, it is inappropriate to use that interest rate in valuing benefit liabilities that are guaranteed by State law or constitutions.

Pensions current practice of discounting guaranteed liabilities using returns on risky assets runs counter to economic theory, the practice of financial markets and the accounting standards imposed on private sector pension plans.

As the vice chairman of the Federal Reserve put it, "While economists are famous for disagreeing with each other on virtually every other conceivable issue, when it comes to this one, there is no professional disagreement. The only appropriate way to calculate the present value of a very low risk liability is to use a very low risk discount rate."

Most economists believe that since pension benefits are guaranteed by governments, it is appropriate to discount them using interest rates derived from other government guaranteed investments, namely Treasury bonds. Using an appropriate discount rate, current unfunded pension liabilities are not \$500 billion, as claimed, but over \$3 trillion. Violating this rule, as public pension accounting does, leads to nonsensical results.

For instance, public pensions could erase all their reported deficits and even generate a surplus if only they were to shift all their investments to stocks and assume a 10 percent rate of return. Note the plans actual benefit liabilities would be the same and the market value of their assets would be the same. But by adopting a more aggressive funding strategy and ignoring the risks of that strategy, they could magically generate \$500 billion at the stroke

of a pen. If this seems to make no sense, it is because it does make no sense.

But even today, after the financial crisis and the market meltdown, many public sector pensions are effectively doubling down on risk. Having already doubled the share of their assets going to stock since the mid-1980's, public sector pensions are now the largest single investor in hedge funds and are also moving into private equity.

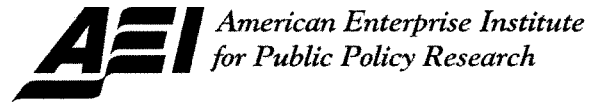
There is no coherent funding strategy that would use these assets to fund fixed guaranteed benefit liabilities. This is particularly so when you note that the public sector pensions operate under a standard called inter-period equity, which dictates that every year, a plan should fully fund the benefits earned in that year and not pass on liabilities to future taxpayers.

But when you fund a guaranteed benefit using highly risky assets, it is obvious that you are passing significant contingent liabilities on to future generations. The more risk you take, the larger these liabilities are.

Using discount rates that economists deem appropriate, public pension unfunded liabilities are somewhere over \$3 trillion. The only way to reduce these unfunded liabilities would be to actually fund them. Most States currently devote 3 to 4 percent of their budgets to pension funding. Using more accurate accounting, that would rise to over 10 percent, in some States significantly more so. Simply taking more investment risk won't do the trick, nor should it.

We face difficult choices, but on one thing we should be clear. It is more important to get the numbers right before you have a crisis, when you still have time to do something about it, than to wait until a crisis has hit. It would be a sad irony if, even as we recover from a financial crisis driven by lax accounting and excessive risk-taking, that we lurched into a new one, driven by the same causes. Thank you very much.

[The prepared statement of Mr. Biggs follows:]



Statement before the United States House of Representatives
Committee on Oversight and Government Reform
Subcommittee on TARP, Financial Services and Bailouts of Public and
Private Programs

“State and Municipal Debt: The Coming Crisis? Part II.”

Andrew G. Biggs
Resident Scholar
American Enterprise Institute

March 15, 2011

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman McHenry, Ranking Member Quigley and Members of the Committee. Thank you for offering me the opportunity to testify with regard to state and municipal debt.

My name is Andrew Biggs and I am a resident scholar at the American Enterprise Institute. However, the views I express today are my own and do not represent those of AEI or any other institution.

The fiscal crisis at the state and local level has many causes. The proximate cause is the significant economic recession from which the U.S. economy still struggles to recover. However, the recession has revealed a number of underlying trends which pose dangers to the future of state and local finance and, in the most extreme cases, may cause these governments to turn to Washington, D.C. for assistance.

The focus of my work has been on financing for public sector pensions, that is, pensions provided to employees of state and local governments. Unlike in the private sector, where the traditional defined benefit pension has been overtaken by defined contribution 401(k)-type plans, in the public sector defined benefit pensions are, if not going strong, at least the predominant form of retirement income provision for government employees.

The accounting standards applied to public sector pensions are far more forgiving than those required for use by private sector pensions or those that economic theory and the financial markets would recommend. Public sector pensions are allowed to discount future benefits, which are guaranteed for workers, using the high expected rates of return on risky portfolios containing stocks, international investments, private equity and hedge funds. Private pension accounting, economic theory, and the practice of financial markets dictate that the appropriate discount rate applied to a given liability is based upon the risk characteristics of the liability, not of funds that may be set aside to fund that liability.

Put simply, public pension accounting standards encourage state and local governments to promise too much, fund too little and take too much risk with their investments. Adequate disclosure of the true state of pension financing will provide markets the opportunity to impose discipline on municipal governments and give policymakers the incentive to act responsibly with regard to these obligations.

The problem with public pension accounting may be best explained through reference to a childhood joke. The question is, "Which weighs more, a pound of cotton or a pound of lead?" Once one

gets beyond the instinct to assume that anything made of lead weighs more than cotton, the answer is obvious: they weigh the same, since both weigh one pound.

Now ask yourself, “Which is worth more, one dollar of stocks or one dollar of bonds?” Despite the temptation to give a faux-sophisticated answer, the true answer is just as obvious: they’re both worth the same, one dollar. Each asset has a different combination of risk and return, but the market places both their values at one dollar. That’s the answer that financial markets would give you, and that’s the answer that economic theory would give you.

But that’s *not* the answer that public pension accounting would give you. In fact, by pension accounting standards, one dollar of stocks is “worth” about \$1.75 of U.S. Treasury bonds.¹ Even if a plan sponsor wished to fund his liabilities responsibly, pension accounting would deem him a virtual fool to do so.

To illustrate, consider a pension that owes a lump sum of \$500 million 15 years from now. It has \$100 million in assets today with which to fund that liability. How well funded is it? Under current accounting standards, that depends on what those funds are invested in. If the plan holds \$100 million in stocks with an expected return of 10 percent, then it discounts the future liability by a 10 percent annual return, generating a present value of \$120 million.² The plan is considered 85 percent funded and has an unfunded liability of about \$20 million.

But now imagine that the plan shifted its assets to U.S. Treasury securities yielding 4 percent. This would alter the discount rate applied to the future liability, generating a much higher present value of around \$275 million. The plan would now be considered only 37 percent funded, with an unfunded liability of almost \$180 million.

This exercise is what public pensions go through every day and is in part accountable for why pension assets have shifted increasingly toward equities, foreign investments, hedge funds and private equity. The more risk you take, the better funded you look. Indeed, public pensions around the country could erase their reported \$500 billion underfunding – on paper at least – by shifting to an all-equity portfolio with an expected return of 10 percent. Such a portfolio shift would do nothing to improve

¹ If the average pension liability lies 15 years in the future, the effect of an 8 percent return on equities versus a 4 percent return on U.S. Treasury bonds would be $1.08^{15}/1.04^{15} = 1.7619$

² E.g., $\$500/1.10^{15} = \119.70 .

pension funding in reality, but it would violate neither the mathematics nor the underlying logic of current pension accounting standards.

But this dynamic is completely foreign to economists and to financial markets. After all, the plan's liabilities are the same in either case: \$500 million, payable in 15 years' time. And the market value of the plan's assets is the same in either case: \$100 million. But by holding stocks and taking more risk, the plan improves the government's bottom line by almost \$160 million. Public pension accounting clearly – almost brazenly – violates the “no arbitrage” principal that is fundamental to modern financial economics. Because public pension accounting ignores risk, it acts as if money can be created out of thin air.

Economists view things differently. In financial economics, the discount rate applied to a future liability is based upon the risk characteristics of the *liability*, not of any assets set aside to fund the liability.³ This is fundamental both to the economic theory and to how financial markets work in practice from day to day. If accrued public sector pension benefits are guaranteed – as plan sponsors intend them to be, and as state laws and constitutional provisions make them in practice – then they should be discounted at a low interest rate that reflects that guarantee.

Doing so, total public pension unfunded liabilities rise from a reported value of around \$500 billion to over \$3 trillion. Public pensions, rather than being about 80 percent funded on average, are only around 40 percent funded. To put this in perspective, the Department of Labor deems any private pension that is below 80 percent funded “endangered” and below 65 percent funded “critical.”⁴ If public pensions were required to use private pension accounting, there would not be a single plan in the country that was not considered “critical.”

Moreover, as policymakers and plan managers have discovered the seemingly infinite powers of a high discount rate, public pension portfolios have shifted increasingly toward risky investments. The share of public pension assets held in equities has doubled since 1985⁵ and pensions are increasingly shifting into “alternate investments” such as private equity and hedge funds. The economic rationale for such investments is poor, given that pension assets are intended not simply to maximize return but to insure that plans have sufficient funds to pay guaranteed benefits whenever they are needed, without

³ This derives from the Modigliani-Miller theorem in corporate finance.

⁴ Life and Health Insurance News.com (2009). “The Big Pension Freeze.” May 19.

⁵ <http://www.lifeandhealthinsurance.com/News/2009/4/Pages/The-Big-Pension-Freeze.aspx>

⁶ Source: Federal Reserve Flow of Funds Account of the United States.

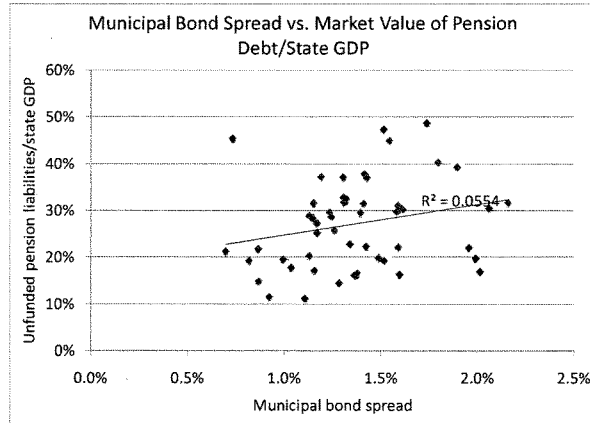
recourse to additional taxpayer funds in the future. Public pensions seem to practice almost nothing in the way of asset-liability management, but in a sense their job should be almost nothing *but* asset-liability management.

The Governmental Accounting Standards Board is considering revisions to its accounting standards for public pensions that economists hoped would bring public pension accounting in line with economic theory and private pension standards. But based on preliminary recommendations released last year, GASB's revised standards would be, if anything, even less coherent than its current rules.⁶

For all these reasons, I favor steps that may aid policymakers, financial markets, and the public in understanding the role that public pension obligations play in overall state and local finances. For one, the Public Employee Pension Transparency Act, sponsored in the House by Rep. Devin Nunes (R-CA) and in the Senate by Sen. Richard Burr (R-NC), would require states to disclose the market value of pension obligations using an appropriate discount rate. It would not force states to alter their own accounting or change their funding, but if sunlight is the best disinfectant then additional information may help everyone in gathering the courage to address these issues.

But all of this leads to a separate question: how large a role should unfunded pension liabilities play in determining the credit ratings for municipal bonds? Others are far more qualified to answer this question than I am, but I would note this: in practice, pension obligations have been senior to explicit debt in order of payment, such that the size of unfunded pension obligations has a direct bearing on the risk of government debt. In New York City in the 1970s, Orange County, California in the 1990s and Vallejo, California today, full public sector pensions were and are being paid even as bondholders and other stakeholders accept cuts. Without debating whether this should be so, there is no doubt that our assessments of the risks of government debt should bear this fact in mind. For each dollar of outstanding state government debt, there are three dollars of unfunded pension liabilities that must be repaid first.

⁶ See Biggs, Andrew G. "Proposed GASB Rules Show Why Only Market Valuation Fully Captures Public Pension Liabilities." *Financial Analysts Journal*, March/April 2010.



In preliminary analysis for my own work, I found that the market value of unfunded public pension liabilities currently has almost no direct bearing on the credit ratings of state bonds.⁷ However, the accompanying chart, showing the market value of unfunded pension liabilities as a percent of state GDP

and the spread on state municipal bonds relative to the Treasury rate, shows a small but significant bearing between the two, such that greater pension liabilities correlate with higher borrowing costs. Other more sophisticated studies have found a modest relationship between pension liabilities and state borrowing costs⁸, but it is smaller than one might assume given the prominence of pension funding in public policy debates.

It may be that these results are not problematic. Currently, pension funding for most states takes up only 3 to 4 percent of their total budgets,⁹ down from almost 6 percent of budget from the 1950s through the mid-1980s. This decline matches the upward path of equity investment in public pension funds, which due to the effects of higher discount rates would reduce current funding requirements.

However, many states already are having difficulty meeting pension funding demands and using market valuation of pension liabilities the typical state would need to devote roughly 10 percent of its budget to funding pensions. In certain states, such as California, New Jersey and Illinois, pension funding could take up significantly larger shares of total budgets. Amidst rising Medicaid costs, increasing costs

⁷ Biggs, Andrew G. "An Options Pricing Method for Calculating the Market Price of Public Sector Pension Liabilities." American Enterprise Institute Working Paper. February 26, 2010.

⁸ See Novy-Marx, Robert and Rauh, Joshua D. "Fiscal Imbalances and Borrowing Costs: Evidence from State Investment Losses." May 21, 2010. Munnell, Alicia H., Aubry, Jean-Pierre, and Quinby, Laura. "The Impact of Pensions on State Borrowing Costs." Center for Retirement Research, SLP#14. February 2011.

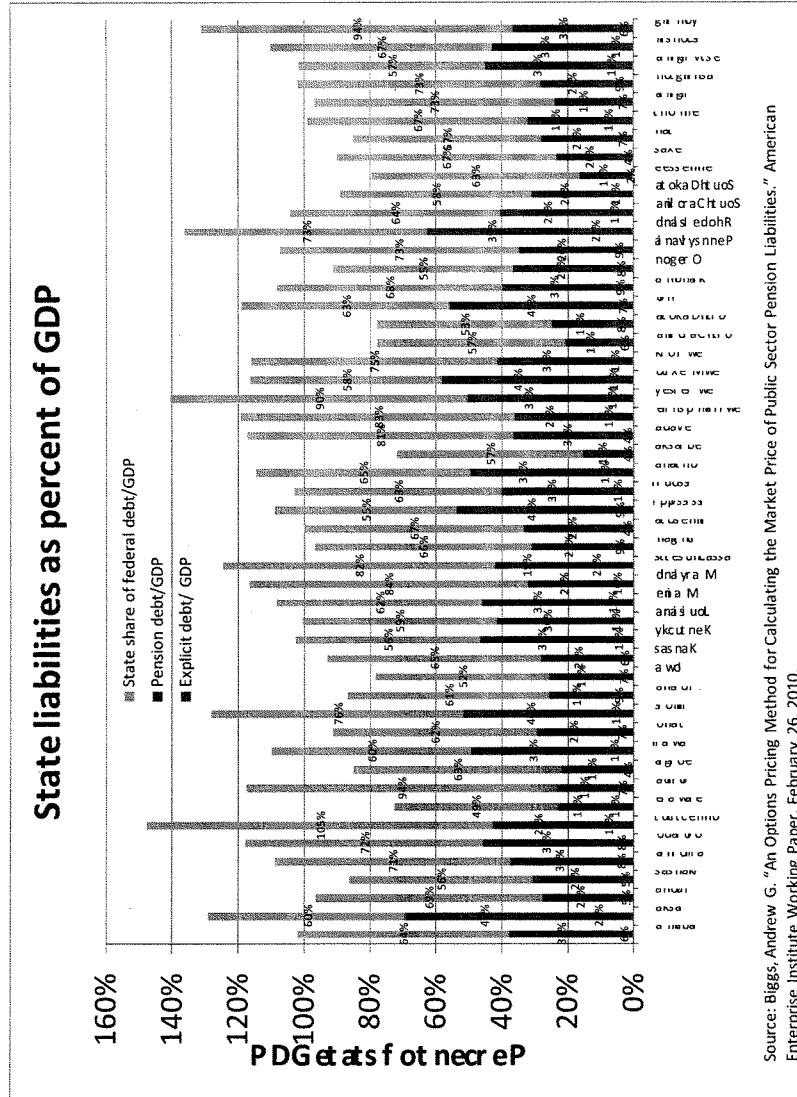
⁹ Munnell, Alicia H., Aubry, Jean-Pierre, and Quinby, Laura. "The Impact of Public Pensions on State and Local Budgets." Center for Retirement Research, SLP#13. October 2010.

for retiree health care for public employees and other concerns, devoting that level of resources to a single aspect of public activities may be considered troubling.

However, credit rating agencies consider a large number of factors in assessing creditworthiness and both explicit debt and pension liabilities are not foremost among them. Establishing models to calculate the probability of extremely unlikely events is difficult; we cannot know with certainty how large a role excessive debt, explicit or implicit, plays relative to other more immediate factors in determining if a government will be unable to meet its debt obligations.

We do know, however, that debt at all levels of government is rising and that there is only one economy and one set of taxpayers that the federal, state and local governments can rely on to service this debt. The combined value of explicit state debt, the market value of unfunded state pension liabilities and publicly-held federal debt equals around 100 percent of U.S. gross domestic product, a troubling value given the significant fiscal challenges lying ahead. Indeed, as the figure on the following page shows, when states' shares of the rising federal debt are included, many shoulder total debt burdens approach those that brought Greece and Ireland to fiscal ruin. While the analogies should not be overextended, it is not an exaggeration to say that rising debt should be a central focus of public policy at the federal, state and local levels over the next decade.

The sooner policymakers and the public are made aware of true levels of pension and other obligations, the sooner and more effectively we can act to address them. It would be ironic indeed if, even as we recover from our last self-inflicted financial crisis – caused by lax accounting and aggressive investing in housing – we stumbled into our next, founded in the same basic errors.



Mr. MCHENRY. I certainly appreciate your testimony. I will recognize myself for 5 minutes.

Mr. Kurtter, in your testimony you affirm that combining both debt and pension metrics will improve transparency for investors. Can you please name specific measures that States can adopt to enhance transparency?

Mr. KURTTER. Thank you, Mr. Chairman. We published a report recently, Combining Debt and Pension Metrics into one Metric, for purposes of providing increased transparency to the marketplace for purposes of evaluating credit risk. We did that because we were trying to conform with practices in other business lines, the way corporations are looked at and hospitals. Our goal is improved transparency for the investors who rely on our ratings.

Mr. MCHENRY. What specifically could States do? In terms of public policy, what can we do to enhance disclosures for investors?

Mr. KURTTER. We don't advise or make recommendations.

Mr. MCHENRY. OK, then if that is your answer, that is your answer.

Mr. Prunty, would you answer the same question?

Ms. PRUNTY. We have looked at pension liabilities as part of our criteria for many decades. I think that the challenge, when you look at public plans, is that the current governmental accounting standards allow for a range of actuarial assumptions when they are calculating those liabilities. So it is very difficult to do an apples to apples comparison among States and among local governments as well.

So we do report those liabilities and have reported those alongside debt, and give them equal weighting when we are evaluating the debt and liability profile. But I think that some of the variability and the actuarial assumptions that are allowed definitely make it challenging to do that kind of comparison.

Mr. MCHENRY. Would uniform disclosures assist in credit rating and transparency for investors?

Ms. PRUNTY. I think there are current efforts underway with the Governmental Accounting Standards Board to look at that issue. We are obviously watching that closely.

There are a lot of unique features, as you go from plan to plan. They are not uniform plans, government by government. So I think that the one size fits all solution is probably a little bit challenging there. But certainly, a little more uniformity would make it easier to make comparisons across governments.

Mr. MCHENRY. Mr. Kurtter, would uniformity assist?

Mr. KURTTER. Yes. We are in favor of more uniformity and consistency and transparency across the marketplace in terms of reporting this information.

Mr. MCHENRY. Thank you. In comparison of the corporate bond market to the muni bond market, is there more disclosure in the corporate bond market than in the muni bond market? Ms. Prunty.

Ms. PRUNTY. When we are assigning ratings, we are generally relying on the information provided by issuers. Based on our criteria, we are assuming that—

Mr. MCHENRY. If you don't want to answer the question, it is fine. I don't have much time. Is there more disclosure, more trans-

parency in the corporate bond market than municipal bond market? Yes or no.

Ms. PRUNTY. Yes, I've been in public finance my entire tenure at S&P, so I am not familiar with the corporate.

Mr. MCHENRY. Mr. Kurtter.

Mr. KURTTER. General disclosure or pension disclosure, Mr. Chairman?

Mr. MCHENRY. Both.

Mr. KURTTER. Both.

Mr. MCHENRY. Or either. Whatever you would like to answer. I am just trying to get an answer from you guys. And this is a beef. I have to be honest with you. This is a beef with the credit rating agencies, is you guys talk around the problem and actually not address it. This is the frustration that many of us have, and I think the marketplace has with this.

Mr. Kurtter.

Mr. KURTTER. Yes. In corporate disclosure generally, there is interim financial reporting and other types of more timely reporting. Municipal disclosure, the audits are typically often late, and there is no interim financial reporting. That said, I think it is important to recognize that in a public finance marketplace, there are many resources of publicly available information that are not available in the corporate world. Budget information, revenue reporting, things that are publicly available as a consequence of the budgeting process.

Mr. MCHENRY. In terms of what has happened in Ohio, according to municipal bond strategists, upon the recent passage of Ohio State union reform legislation, the cost of borrowing reflected by the yield of the State's long-term general obligation bonds fell by a meaningful percentage, and dropped the cost of borrowing for Ohio, post-passage of this union reform legislation, basically the collective bargaining agreement.

Mr. Kurtter, can you touch on this? Would you be willing to touch on that?

Mr. KURTTER. The existence or non-existence of collective bargaining is not in and of itself determinative of budget balance or the likelihood that an entity will acquire large unfunded liabilities or large post-retirement liabilities. From our perspective, we look at the bottom line, it is whether the budget is balanced rather than how a budget is balanced.

Mr. MCHENRY. But it has a meaningful effect on the marketplace, though it didn't create, change the rating, it did change the rate that people were paying, the State was paying.

Mr. KURTTER. I don't track the pricing, so I trust that is correct.

Mr. MCHENRY. With that, I recognize Mr. Quigley for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Dr. Baker, you are a little more optimistic on the overall picture than some. And on the overall picture, that is probably accurate. Wouldn't you concede that for six to eight States on the pension issue it is far more acute a problem and far more dramatic action has to be taken?

Mr. BAKER. Thank you, Ranking Member Quigley. I am usually not known for my optimism.

You certainly do have several States, the ones you had mentioned on that list, that clearly have more serious problems. We have a number of States that, had we not gone into the downturn, their pensions would be pretty much fully funded. We had other States that faced problems even prior to the downturn, and certainly the situation was made considerably worse by the downturn.

As you know, in your own State, Illinois, of course, they did have a substantial tax increase in part to deal with those problems. I suspect you will see comparable actions in other States.

Mr. QUIGLEY. But is that enough? Even Illinois is still borrowing a significant amount of money to meet those obligations. Are you suggesting, with all due respect, they could all be made up for with additional revenue?

Mr. BAKER. I don't mean to tell the States how they should deal with their shortfalls. But I will say one thing that is front and center, is the state of the national economy. If it were the case that we were somewhere near full employment today, Illinois and every other State would see both a much better overall budget situation and as well its pensions would likely look better, both because there would be more money flowing into it, regular money flowing into it. And then on top of that, I would anticipate the stock market moving back toward more normal levels.

Mr. QUIGLEY. Well, if we believe in collective bargaining, we should also believe in collectively solving the problems. I guess what I am trying to get you to is that it is not just the economy or additional revenues. There has to be some meeting in the middle. At least some of these pensions, you would agree, have been a little too generous, a little too out of synch with actuarials in terms of when people start collecting, how long they collect, how long they pay in, the COLAs that are involved.

Mr. BAKER. Well, a couple of points I would make on that. Pensions are part of an overall compensation package. There have been a number of studies, we have done some at my center, a number of other organizations around the country, academics have done studies, looking at public sector compensation in general. The conclusion of the bulk of these studies, I know Dr. Biggs has opposite conclusions, but the conclusion of the bulk of these studies is that public sector workers are paid a little less, taking into account their pension commitments, than private sector workers, adjusted for education.

Now, having said that, are there cases where I think pensions are inappropriate, where maybe workers are allowed to retire too early, where they are perhaps structured inappropriately, it is common for pensions to just be based on the last 3 years or the last 1 year, I wouldn't do it that way. But again, I am not setting the laws for State pensions.

Mr. QUIGLEY. I agree. We are both in that situation.

Mr. Prunty and Mr. Kurtter, you seem fairly confident that we are not in for a major default in the next year or so. But stranger things have happened when the experts haven't picked up. The issue that I am most concerned with is the impact on the market as a whole, even the bond market. Is there a contagion factor, if a major State had a major default?

Ms. PRUNTY. Thank you. We do, our current rating would suggest that we don't see a default for Illinois, and actually their bond—

Mr. QUIGLEY. Or any State.

Ms. PRUNTY. Yes, or any State. Illinois has actually, over the last year, during the last legislative session, put some protections in to ensure that there was sufficient special funds on hand in order to cover future years' debt service obligations, both short and long-term, and so have made some adjustments there in order to focus on that.

Mr. QUIGLEY. But the question still stands. Given a possibility in this country of a major default, is there a contagion factor? Or is this all isolated in terms of how you rate funds?

Ms. PRUNTY. I think defaults historically, if you look at New York City back in the 1970's, there was a significant focus on the market and the impact there. I think that is why you see so many oversight mechanisms across States to prevent local government from being in a default situation for exactly that reason, that there would be concern that there would be implications for the broader market.

Mr. QUIGLEY. Mr. Kurtter, quickly.

Mr. KURTTER. Yes, thank you. The markets clearly are very jittery right now. We don't believe there will be major State defaults. We don't believe that there will be more than a few small rated defaults among local governments.

But clearly the markets are jittery, and any kind of a significant default would add to the nervousness of an already jittery market.

Mr. QUIGLEY. Thank you.

Mr. MCHENRY. The gentleman's time has expired.

Ms. Buerkle, for 5 minutes.

Ms. BUERKLE. Thank you, Mr. Chairman, and thank you to our panelists for being here today.

My district is in upstate New York, so if you will indulge me, for my 5 minutes I would like to talk about the State of New York, and in particular because it is one of those 44 States that the chairman spoke of in his opening remarks.

Dr. Biggs, I would like to just direct my question to you, and then to Mr. Kurtter, and then if anyone else would like to comment on it. In 1975, New York City found itself in a crisis and had to make a decision between paying its debt or paying its employees. As you know, they paid their debt down.

My question is, do you foresee New York State being in, facing such a choice within the next 5 years? And if you could comment on how dire you believe the situation is in New York at the present time.

Mr. KURTTER. I know a little bit about New York State. My father is from upstate New York, near Schenectady, so I spent a bit of time up there. I would not claim to be an expert on New York State finances.

Certainly in the recent history, it has not been encouraging there. New York State's pensions have been better funded than in many States of the country. But when you use honest accounting, that is being the top of a very bad heap. But still, the other costs the State government has to deal with are pretty significant.

I have not followed closely enough the efforts of Governor Cuomo there to try to rein in some of the costs and to bring balance to the budget. If those are successful, certainly New York will be in better shape. I think because of New York's reliance on tax revenue from Wall Street, which is highly cyclical, they have a risk factor there that some other States may not have.

So certainly I am hopeful and more hopeful now than I was 6 months ago. But New York State has a long way to go.

Ms. BUERKLE. Thank you. Mr. Kurtter.

Mr. KURTTER. Yes. Our ratings really speak to whether or not we expect the State to make good on its bond payments in full and on time. That said, of course, the State has had very difficult problems, as all States have, are facing tremendous problems of managing their revenue and spending. Our view is that the States have revenue and spending problems, but not really debt problems, because even in New York, their debt service is a relatively small portion of their overall spending.

Right now, of course, because revenue is short, payments to the retirement system and all other expenses are competing with each other for scarce dollars. And the State is having to make difficult choices about meeting, balancing their budget within the constraints of weaker revenue.

Mr. BAKER. Let me just quickly add to that, just to remind the committee that first and foremost, the state of the economy will be the most important factor determining the ability of New York and every other State to meet its obligations.

Ms. BUERKLE. Thank you, Dr. Baker.
Senator.

Mr. LILJENQUIST. You asked the question whether or not New York is in a situation where they need to pay their debt or pay their employees. Utah is in that situation right now. As we ramp into 75 percent increases in our employer contribution for pension systems, that is going to pay for these losses. That is 10 percent of our general fund that will not be available for wages or health care benefits for our employees.

We fund things in this order in our State, and I think most States are similar. We fund pension benefits first, health benefits second, and whatever change is left over goes to wage. And our wages in the State have fallen behind as we have struggled to keep up with pension and health care costs.

So as we looked at our reforms, we started calling it, maybe euphemistically, the wage liberation act. Because we said, look, you can't have a set bucket of money and having your benefits eat more and more of that bucket of money. You have no money left for wage.

So we struggle to get the 24 year old, at the start of his career, because he or she is looking for wage, and benefits are less important. And we struggle to recruit, as a State. We think by affirmatively saying, and generous, our legislation says you get 10 percent toward your retirement, 10 percent of your wage. If you are public safety or fire, you get 12 percent. So it is a generous amount, but it is set. And that is all we are doing. So hopefully over time, we can repair wages for our employees, which by our data in the State of Utah, their actual wage is lower because we are making this

choice, do you pay this debt or do you pay the employees. And we are struggling with that right now, as a State.

Ms. BUERKLE. Thank you. I yield back my time.

Mr. MCHENRY. Mr. Welch for 5 minutes.

Mr. WELCH. Thank you, Mr. Chairman.

Senator, congratulations on your success in making some progress in dealing with this in Utah. You have to give us the magic potion so we can make some progress here.

One of the things we are struggling with is our own deficit. And the new majority is, in my view, rightly focusing on that. But there are consequences to some of the policy decisions we make. I just want to ask, I will start with Dr. Baker, what is the impact on the States in their ability to address, among other things, this under funding of the pension, if we have \$100 billion in cuts that include substantial revenues that the States have been depending on? Is there an impact?

Dr. BAKER. I certainly expect there to be an impact, to some extent. These are revenues, as you say, that would be committed to the States. But I think probably the bigger impact is that there have been a number of estimates, Mark Zandi and Moody's and Goldman Sachs came up with estimates that this could lead to loss of as many as 700,000, 800,000 jobs. This means more people unemployed, slower Economic growth, less tax revenue to the States. I think that actually is likely to be the bigger impact, due to the impact on the economy, than sort of direct impact in terms of cutting money to State governments.

Mr. WELCH. Thank you.

Mr. Kurtter, how about you? And again, these are policy choices we have to make. There is not endless money. We here in Congress have to bring us back to fiscal balance. But I also think we have to be clear-eyed about the impact of some of these cuts, when it is revenue that goes to the States, and then how that impacts their ability to deal with their own fiscal problems. Do you have a comment on that question?

Mr. KURTTER. States are beginning to face the fiscal dilemmas that they are challenged with right now. They are making very difficult spending and revenue cuts, touching programs that in prior years were off limits. These are tough choices elected officials have to make.

With regard to pension obligations, they are also beginning to address some of those issues, too, by increasing employee and employer contributions as well as addressing the benefit side of the equation.

Mr. WELCH. Ms. Prunty, how about you?

Ms. PRUNTY. Yes, I think it is fair to say that the budget climate is still very difficult for States. If there were any reductions in revenue sources, be it Federal or other tax sources, it would add additional difficulty to the current budget challenges. Particularly because Medicaid is a very large portion of State spending, and that is the primary Federal flow of revenue to States. So yes.

Mr. WELCH. Thank you.

Dr. Biggs, I think you made a very compelling point in terms of the investment models and what is realistic. You can't have a pie in the sky kind of projection.

But on the other hand, is it equally questionable as to whether there should be this so-called risk-free model that imposes what historically I think is a much lower rate of return, where there are consequences to State budgets if you have a so-called risk-free model where you can give yourself the, perhaps satisfaction that you “guaranteed” to have that return, but on the other hand, there is a consequence with respect to how much then has to be put in to fund it. It may be more.

Mr. BIGGS. Sure. Well, I think it is important to repeat that the use of a riskless or a risk-adjusted discount rate is the way you value your liability. It doesn’t restrict the plan, if it wishes to invest in equities or invest in more risky assets. And the plan will benefit from those investments if they pan out. If they invest in stocks and the stocks generate higher returns, then they actually have more assets on hand than they otherwise would have.

The objection is to essentially assume that those assets will generate 8 percent returns going forward without taking any risk into account. If you go back to the 1980’s, up to the——

Mr. WELCH. Let me just get clarification, because I think this is quite important. If you have a riskless model where you are saying it has to be the T-bill rate, let’s say, where there is some, we hope the Federal Government is good for it, that can have a depressing impact on the ability of a State to meet many of its other legitimate obligations, including what the Senator was talking about, trying to bring up the wage scale.

Mr. BIGGS. Sure. If you value your liabilities correctly, the liability is what it is. How you fund a liability is an entirely distinct question from what the liability is. Plans today, State pensions generally take an aggressive funding strategy, which means they invest in stocks and hedge funds, things like that. The higher expected return means they can make a lower contribution today. And people like that. It leaves more money for other things.

But because the benefit is guaranteed, it means a higher contingent liability on future taxpayers. That is inconsistent with the standards that GASB lays out that says, you should try to fully fund your benefits as they accrue and not pass contingent liabilities. Well, what we are finding out today, again going back to the mid-1980’s, before then you had a high level of funding into State pensions, but conservative investments to go into them. They would invest mostly in bonds and things like that.

That meant you had to put a lot of money away. You didn’t have a large contingent liability. Since then, they went more aggressively into stocks, which essentially cut their funding levels in half. For many years, you had good times. The stocks returned well, they increased benefits, they had funding holidays. Today we are seeing the flip side of that strategy.

So you can’t take an aggressive, risky strategy and expect that you are never going to have to deal with the downside. That is currently what we have.

Mr. MCHENRY. The gentleman’s time is expired.

Mr. Meehan of Pennsylvania, for 5 minutes.

Mr. MEEHAN. Thank you, Mr. Chairman.

Thank you to each of the panelists for your articulation of a lot of details on a very, very challenging issue, certainly for those who

struggle at the local level. I often think about these things in the context of municipalities, not just the States, where there is a greater capacity to handle these, but a lot of local obligations that have been undertaken for everything from funding local economic development to other kinds of programs.

I am thinking about the implications that are going to be sort of bleeding down, particularly as we aren't able to predict yet what States are actually going to be doing with their budgets. But the implication is that much of it is going to be pushed down to the local level as well.

I think Ms. Prunty and Mr. Kurtter, you discussed this issue, which I don't clearly understand, which is the role of accounting in municipal finance, which may be different from what we do with a publicly traded company. And the fact that we may be understating the risk, because of the method of accounting. Can you explain to me what the difference is between municipal accounting and accounting that is done, say, for a corporation, and their tax filing?

Ms. PRUNTY. I think on the Governmental Accounting Standards Board side, there is a different government, I think there is a recognition that they are different from corporations, because they are going concerns, and it is unlikely that they will be out of business going forward. So the Governmental Accounting Standards board does allow a different set of assumptions to be used for public pension accounting. And that has been the case. There is significant discussion underway at the Governmental Accounting Standards Board to look at that and determine if that is still appropriate, given market performance of the last decade.

But I think that the accounting differential really recognizes the fundamental difference between governments and corporations.

Mr. MEEHAN. Is it exclusive to pensions, or does it involve other kinds of general obligation bonds as well?

Ms. PRUNTY. The Governmental Accounting Standards Board also covers the annual financial statements or financial audits that governments provide. So there is a differential in accounting standard there, also, recognizing some of the differences between corporations and governments.

Mr. MEEHAN. If it is understated, and that was the testimony, I believe it was you or Mr. Kurtter, was there somebody that testified today that local, there is sort of an understatement of the problem? Dr. Biggs, you did. Would you then answer my question?

Mr. BIGGS. The standards used by the Governmental Accounting Standards Board [GASB], allows States or municipalities to discount their liabilities at the expected rate of return of any assets they have set aside to fund their liabilities. So if they think their assets are going to return 8 percent, they can discount the liability at that. That applies mostly to pensions. It would apply in some limited cases to retiree health care. Some States pre-fund their health care obligations. Most don't.

So in the private sector, a private sector pension plan could discount its pension liabilities at the rate of return or the yield on corporate bonds, which are currently around 5½ percent. So the effect of the differences in the discount rates is really very, very large between the private sector and the public sector.

Mr. MEEHAN. Thank you for that explanation.

I just have one remaining question. Mr. Kurtter, let me ask you this one. In my review for this hearing, there was a discussion about the fact that the Federal Reserve looks as if they are going to decrease their participation in the purchases within the bond market. Do you have any sense as to what impact that is going to have on the interest rates, and a prediction about how high those interest rates may go?

Mr. KURTTER. Yes, Mr. Congressman, that is really something that is really outside my area. I am a State and local government analyst, and I don't really have an opinion on these kind of larger macro issues.

Mr. MEEHAN. OK. Is there anybody on the panel that does have a feeling on that issue?

Mr. BAKER. Well, the consensus, if you look at the Congressional Budget Office, and just about every other forecaster out there, is that the interest rates will head upward. They are extraordinarily low levels today. Assuming that we do see some sort of economic recovery, it is reasonable to expect that they will get to more normal levels.

Mr. MEEHAN. Thank you.

Mr. MCHENRY. With that, I yield the full committee ranking member, Mr. Cummings, 5 minutes.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

I want to thank our witnesses for your testimony.

Dr. Baker, one of my concerns in having been now in State legislature for 15 years and been here on the Hill for 15 years, you see a lot of times folks trying to deal with a problem as if that problem is going to last forever. And they deal with it, and then things get better.

When I listen to a lot of the discussion, I am worried about folks who, when the economy comes back, we try to make these changes, and it will be hard to reverse it. Do you follow me? Is that one of your concerns, too?

Mr. BAKER. Absolutely. Again, I was on the other side of this argument a few years back, because I did feel that given price to earnings ratios in the stock market in the 1990's, particularly when we had the bubble, that pension funds, both on the private and public side, were being hugely over-optimistic. Now, we have a serious downturn. Much of the pension fund shortfall likely will go away when we get future year valuations, because of course, the market has recovered much of its lost ground.

I am not saying it is going to go away 100 percent. But we are looking in many cases at funding periods that were very near the trough of the market. Now, there is averaging, so it is a little more complicated than that. But we are in many cases looking at funding periods that were near the trough of the market. The market has recovered much of its value. I don't have a crystal ball, so I can't tell you it will recover all of its value. But it is almost certainly going to be the case. They will look better simply from that recovery.

Again, if we had the economy back on its feet, if we were back near 5 percent unemployment, we would be looking at a much better situation in general for State and local governments. So the

idea that we are going to be in perpetual crisis, I can't roll that out. But I think that is going to be more determined by the situation of the macroeconomy than the finances of State and local governments themselves.

Mr. CUMMINGS. That leads me to my next question. Probably the most poignant example of how politicians use pensions and public employees as their scapegoat is the battle that has transpired in Wisconsin on this issue. As a February 22, 2011 Huffington Post article explains, it says, "While Governor Scott Walker has painted a dire picture of his State's pension obligations, Wisconsin's pension fund for public employees is among the Nation's strongest, according to a report by the non-partisan Pew Center. The Pew Report issued last year concluded that Wisconsin is a national leader in managing its long-term liabilities for both pension and retiree health care."

Dr. Baker, according to that same article, Governor Walker used his State's pension obligations to argue for a need to revoke collective bargaining rights of State employees. I am just wondering if you had an opinion whether such a drastic step was necessary, or was that an example of a scare tactic that you have discussed in your report of February 2011, entitled *The Origins and Severity of the Public Pension Crisis*?

Mr. BAKER. I won't claim to be an expert on either Wisconsin's funding or Governor Scott's motives. But I will say from what I know of its funding, it is very close to fully funded. They have been very responsible. And I will point out that again, just to be as clear as I can here, pension is part of the overall compensation. There have been analyses specifically of Wisconsin's compensation packages. Jeff Keefe, at Rutgers University, looked at it and found that public sector workers receive somewhat less total compensation than comparably educated, experienced private sector employees.

If you are to cut the pensions in some way, you could no doubt in the short term save some money. But workers expect comparable pay. If you are reducing public sector compensation, you could either say, well, maybe we won't get good workers in the future, or alternatively, maybe you will have to make that up in other pay. And again, the defined benefit is very important. Workers value that certainty. And again, this gets back to this issue Andrew was raising, that States can bear the risk. If you have a downturn and there are 2, 3, 4 years where the market is down, where things look bad, States can get through that risk, as long as they have in general been responsible.

If you or I retire and the stock market is down, we are out of luck. There is nothing we can do about that. So by virtue of taking that risk, that is a very big benefit for workers, that they are willing to give up other compensation for. We would lose that if we end defined benefit plans.

Mr. CUMMINGS. One of the things, when you talk to workers, particularly ones in my district, they tell me that when they were voting for various, during union negotiations, that they took less pay because they were worried about the benefits when they retired.

Mr. BAKER. It is very common. Public sector workers have lower pay by almost every measure than private sector workers, straight

wages. But they have somewhat better pensions and health care benefits.

Mr. CUMMINGS. Thank you, Mr. Chairman.

Mr. MCHENRY. The gentleman's time is expired. And with that, I recognize the full committee chairman, Mr. Issa of California.

Mr. ISSA. Thank you, Mr. Chairman. Thank you for holding this important hearing.

Dr. Biggs, we have a constant debate, it seems, on public and private sector activities, union, non-union. The ranking member went on quite a bit acting as though it is a scapegoat. Don't we have basically a difference between unionized private sector workers and public workers, particularly in that, in the private sector, a unionized worker is in Social Security, while in the public sector, at all the State levels, virtually, they are in a system that has their high pay opted out of Social Security and often Medicare, which means they are out of a system and into their own system, which is not fully paid for.

As I think Dr. Baker made very clear, they have this safety net, which is current overseers, the elected officials and/or the elected representatives, can make a deal that ultimately they know cannot be kept in the future without unrealistic expectations of growth in their bonds. Typically in California they were assuming a growth that you could not find in any index, but you could find it for a short time in PERS and STERS. Would you like to give us a little insight into that part of the problem we are dealing with in these pensions?

Mr. BIGGS. Well, this I think is an important issue, because one question, how you resolve some of these pension financing issues, comes down to your perceptions of how well or how poorly paid public sector employees are. You are right that many public sector employees don't participate in Social Security. That is sometimes pointed out as though they are losing something in that regard. I don't want to downplay the important protections that Social Security provides. But as a general deal, public sector pensions are a far better deal for them. Social Security would pay them on average a rate of return of around 2 percent of their contributions. Under the typical public sector pension, they are effectively guaranteed a rate of return around 8 percent. Compound that over your full career, and it is an enormous difference.

You also tend to get, in the State and local sector, retiree health care, which can be very generous, and often that is not included in the private sector. Congressman Cummings was just mentioning employees in Wisconsin. I know Milwaukee teachers, for instance, receive retiree health care that is worth around 20 percent of their pay. The sort of pay studies we have heard about today saying that State and local employees are underpaid, it doesn't include retiree health care. It also tends to undercount the pension benefits they get.

So we want to get a good feel for where things stand. We have to compete for workers with the private sector. If you are in any low level of government, you don't want to underpay people. But it takes careful analysis to be able to tell whether they are being fairly paid or not.

To touch on your last point, the assumptions that go into the pension financing and things like this, I focused on the assumed rate of return, and that is the most important one. There are many other things that can be jimmied around. Illinois had some problems where they would cut benefits for workers that haven't even been hired yet and book those savings today. There have been examples in Washington State where their actuary said, you have to better account for the longer work lives of people, and the board said, no, we are not going to do it.

Mr. ISSA. And I am going to cut you off, I apologize. It is a good train of thought, and certainly in San Diego, we have a scandal where that has been well codified in criminal prosecutions.

Dr. Baker, I saw you startled when I talked about the unrealistic expectations of the growth in PERS and STERS and so on. I heard you say earlier, with the ranking member that, well, the markets have come back. But isn't it true that if you were broadly invested, you in fact over the last 3 years had effectively net zero? And net zero is 24 percent compounded less than the anticipated amount that these contributions were based on. Can you sit here today saying that anyone on this side of the aisle should have confidence in these retirement plans, if they assume 8 percent growth rather than, let's just say, inflation plus 1 or 2?

Mr. BAKER. I don't think there is anyone who has been more critical of overly optimistic returns in the stock market than I am. And I base that on price to earnings ratios. They were very high in the 1990's. They were still somewhat high in the last decade. They have fallen a great deal. Future returns depend on current price to earnings ratios. Now that the price to earnings ratio is considerably lower, if you look out over a 20, 30 year horizon, then yes, I could look to your side of the aisle and say yes, I think those returns are very reasonable, and have done the arithmetic.

Mr. ISSA. OK, well, I hope you are right. Let's do another half of this. Dr. Biggs, back to you for a second. We have historically low interest rates today. We have a huge, ballooning Federal deficit, but my own State of California and many others have built up a lot of debt. What happens if we return to, if you will, somewhere between where we are today and where we were in the 1970's? What happens to both the Federal and the States' ability to meet pension obligations?

Mr. BIGGS. The Federal budget, and to a degree, the State budgets, have benefited from the fact that our financing crisis, our budget problems, have coincided with significant financial problems overseas, which has pushed capital from foreign countries into the United States. That has helped keep our interest rates low. We are very advantaged by virtue of that.

If interest rates start rising back to normal levels, or if they go even further, if markets are not convinced of our ability to get on top of our deficits, then all of this process starts cascading and it happens much, much sooner than we otherwise anticipate. The history of financial crises, whether you are talking about currency crises, banking crises, is they can continue going on normal. But when they happen, they happen very, very quickly.

So I think it is very good and we are very lucky to have low interest rates today. We should not be complacent because of that.

Mr. ISSA. Thank you. I yield back.

Mr. MCHENRY. Thank you, Mr. Chairman. I will now recognize Mrs. Maloney for 5 minutes.

Mrs. MALONEY. First of all, I want to thank the chairman for holding this, and the ranking member.

We are going to the floor shortly on a budget vote to continuing resolution. And in the budget proposals that have come forward for fiscal year 2012, practically every, 42 States have proposed to spend less on education and health care than they spent in 2008 after inflation. States are proposing these cuts, despite the fact that the costs associated with their services will be higher.

So given that backdrop, I would like to ask Mr. Baker, why is it important at this time not to cut Federal funding for State and local governments?

Mr. BAKER. Again, I would say there are two reasons here. One, perhaps the more important, is the macroeconomic reason, that at this point the Federal deficit is supporting the economy. If we were to radically roll back the Federal deficit in 2011, we would see less demand. I don't know of any story I could tell whereby if we cut back spending, laying off public employees, we are going to see retail stores, hospitals, whoever it might be, go out and hire more workers. I don't know a story of an economy that works like that, at least not when you are in the middle of a downturn.

So the macroeconomic picture is very important. The other part of the story is, obviously, many of these programs have the character investment, we are talking about education. If our kids don't get adequate education, because we have 1, 2, 3 years of economic slump, they are not going to be able to make that up. Some of the cuts are in regulatory programs, like the Securities and Exchange Commission, I would think people would be very sensitive to that, recognizing that we clearly had problems of inadequate regulation. We were talking about fraud in the public sector or at least questionable accounting. There clearly was a serious rash of that in the private sector as well. I would think that Congress would be very sensitive to that.

So I think we could pay a big price for it.

Mrs. MALONEY. Well, isn't it true that proposed GOP cuts to Federal funding for State and local governments will force some States to impose higher taxes and to cut vital public services, actions that will hinder economic growth? Could you comment on that?

Mr. BAKER. Most States in the country are facing serious budget shortfalls. They are making cutbacks in a wide range of areas, and many of them are raising taxes as well. One could argue as to how vital those are. But clearly, they are making important cutbacks, and I think most, even the Governors that have been aggressive in supporting those cutbacks I think regret many of them in the sense that they feel they are cutting back services that have real merit. And again, this is not the time, I would think, that you would want to see cutbacks in programs that, say, provide health care for the poor. Because there are more poor now, and it is very hard to argue that they could simply go out and get a job, when we have close to 25 million people unemployed or under-employed.

Mrs. MALONEY. And Mr. Baker, how will State and local governments balance their budgets, without this much-needed Federal

funding? Many States have budget gaps that are huge, including my own State, including the great State of California and others. So how in the world are they going to balance their budgets?

Mr. BAKER. Well, nearly every State has requirements that they balance the budget. There is always some room around that. But in most States, this will mean serious cutbacks in spending and/or increase in taxes, which again, this is not the sort of thing you want in the middle of a downturn. If we were in a situation where the economy were at normal levels of output, we were operating near 5 percent unemployment, you could say, OK, fine, the private sector will pick up the gap. But I don't think credibly can tell that story, given where the economy is today.

Mrs. MALONEY. I want to thank you for your testimony and just conclude by saying that State and local governments have eliminated 426,000 jobs since August 2008, and State budget cuts have eliminated additional jobs in the private sector. In fact, at least 13 of 42 States who have released budget proposals for fiscal year 2012 have proposed layoffs and cuts in pay for public workers, and 8 States have proposed measures such as extending expiring tax surcharges, repealing tax credits or deductions and broadening the base of some taxes, and raising rates. We have been called for a vote, on that sort of depressing note.

Thank you all for your testimony and for being here today. Thank you.

Mr. MCHENRY. Thank you for yielding back. With that, I recognize Mr. Ross for 5 minutes.

Mr. ROSS. Thank you, Mr. Chairman. I will try to be brief.

I am trying to get my hands around this. It appears even though we have had a reduction in work forces, both federally, State-wide and in municipalities, there still exists an unfunded mandate, or an unfunded liability out there, with regard to the defined pension plans. Ms. Prunty, what I am trying to understand is, at some point, as a financial rating organization, you have to look at these pension plans and say, it is too good to be true. You have to look at the investments that they are making in order to fund these, correct?

Ms. PRUNTY. When we are analyzing pension, we do include pension in our review. It is part of our criteria and has been. We look at all of the underlying assumptions, we look at the liabilities, and it is factored into our rating. You will see a differential, for instance, Utah is a triple A rated State. They have very proactively managed those liabilities and looked at their assumptions. You do see us factoring in—

Mr. ROSS. They have looked at it and made adjustments moving away from defined benefit plans, is that correct?

Ms. PRUNTY. That is part of the solution in Utah. But that is not universal across governments. Most of the pension plans do remain defined benefit.

Mr. ROSS. In your statement you say, in general, we believe worst case scenarios regarding pensions will occur only if governments are unable or unwilling to use their powers of adjustment. What would you recommend to be their powers of adjustment in order to avoid the worst case scenarios?

Ms. PRUNTY. I don't think we would have a recommendation on what the power of adjustment is. But I think history has shown that they have the ability to either manage the liability side of the equation or increase contributions or make other adjustments to the overall program and plan. So those are really policy choices that each individual State or local Government will make.

Mr. ROSS. Moving from a defined benefit plan to a contribution plan would be a step in the right direction, would you not agree?

Ms. PRUNTY. I think that we would say that those are, again, policy decisions that each government is going to make on, and we will look at the overall impact on the liabilities.

Mr. ROSS. But from your perspective, from your financial rating perspective, it would be more advantageous to a better rating if it was a contribution plan?

Ms. PRUNTY. I think proactively managing liability is certainly very positive. And making a strong commitment to funding the pensions has historically been consistent with a high rating level.

Mr. ROSS. Mr. Kurtter, I want to go to you for one quick second, because you also are in the financial rating business. If, as the title of today's hearing implies, bailouts on private and public programs, if there were ever to be a bailout, would that not be an assumption, then, that a financial rating service would have to take into consideration when giving a rating, once the precedent is set?

Mr. KURTTER. Our ratings don't assume that the Federal Government will bail out States. We do assume that—

Mr. ROSS. But let's assume that it is done, that a bailout is actually done.

Mr. KURTTER. What we do consider is that the Federal Government has always and by law assumes the cost of emergency response in the event of natural disasters and other man-made events. We do build that into our ratings.

Since the role of the Federal Government in providing bailout, if a State were to need assistance, is uncertain, we don't embed that in our ratings, because we don't have enough precedent to reliably know that investors could depend on that.

Mr. ROSS. It would seem to me, though, that once a precedent is set, then it would have to be considered as a potential assumption in making your ratings.

Mr. KURTTER. A precedent is situationally based, and may be a relative particular circumstance that may not be something we could rely on in the future.

Mr. ROSS. Dr. Biggs, one thing real quickly. Mr. Kurtter points out we do not expect any States to default on their bond obligations in the next 12 to 18 months. Do you agree or disagree with that statement, and why?

Mr. BIGGS. I wouldn't want to overstate my confidence in this area, because it really depends on State by State knowledge. It is also extremely difficult to predict low probability events. If we had defaults every year, we would have very good models for knowing what leads to a default. At this point, they are so infrequent it is hard to say. So I think I would agree, but it is certainly not something I would be complacent about.

Mr. ROSS. OK. And Senator, last question. Given the bad results of many revenue bond projects, should such highly risky projects benefit from tax exemption?

Mr. LILJENQUIST. Pardon me?

Mr. ROSS. On municipal bonds, should we continue to have tax-exempt municipal bonds, or should Congress come into play and say, hey, wait a second, these things are so risky, there is such a high rate of default, we are incentivizing the sale of them with tax exemption, should we as Congress step back and say, you know what, maybe we should readdress the tax-exempt status of these things?

Mr. LILJENQUIST. I think that is a good question. I think the challenge we have more with our municipalities is having them over-extend themselves, because of the free ability of credit. We are addressing that in our State ourselves, trying to make sure that our cities aren't over-extending themselves. We end up being the catch-all for them, so that is something to consider.

Mr. MCHENRY. The gentleman's time is expired.

With that, I am going to recognize the vice chair, Mr. Guinta from New Hampshire, for 2 minutes, and then Mr. Walsh for 3½ or 4 minutes, depending on the time for the votes on the floor. Mr. Guinta.

Mr. GUINTA. Thank you, Mr. Chairman. Thank you all for being here. I will be very brief, because we do have to go over to vote.

A question for Dr. Baker. First of all, do you feel, generally speaking, that the Federal Government should be backing the loans that States are asking for and demanding for their borrowing?

Mr. BAKER. I am afraid I am not sure which loans you are referring to.

Mr. GUINTA. The Build America bonds program.

Mr. BAKER. Oh, I am sorry.

I think a program like that is a reasonable program. One could construct different contours to it, sure. But I think given the situation where we are in the economy, I think it does make sense for the Federal Government to encourage States to engage in infrastructure spending, stimulus of different types. We do need to boost the economy.

Mr. GUINTA. And for the edification of the committee, what is your opinion as to where the Federal Government gets that money from?

Mr. BAKER. Given that we are in a downturn right now, that would mean borrowing. I don't think there is any doubt about if you were to raise taxes, it would be self-defeating.

Mr. GUINTA. OK, so the Federal Government is borrowing the money to give to States so they could borrow to pay whatever obligations they have. I hope that they are not doing it for, I would accept that it would be capital-based projects and things of that nature. But I have seen some States borrow to pay their operating costs, which is obviously not a good thing to do, but I have seen it.

I guess my question would be, this Build America Bonds program is expiring, correct?

Mr. BAKER. That is correct.

Mr. GUINTA. Does that have a negative or a positive effect on, from a rating agency perspective, for the States that are using, that have used that program?

Mr. BAKER. Did you want me to answer that question?

Mr. GUINTA. Sure.

Mr. BAKER. If they reduce their borrowing, if they are no longer borrowing because the program is not there, I imagine it would be pretty much neutral.

Mr. GUINTA. Would Ms. Prunty or Mr. Kurtter agree with that? Where is there an effect, now that this program is lapsing?

Ms. PRUNTY. The Build America Bond program has, the expiration has hit the end of the year. So I think that the Build America Bond program was helpful in expanding the market for municipal bonds. But it wasn't a direct credit issue for State and local governments.

Mr. GUINTA. OK, thank you.

Mr. MCHENRY. With that, I recognize Mr. Walsh.

Mr. WALSH. Thank you, Mr. Chairman.

Dr. Biggs, I was going to ask you a few questions about my home State of Illinois, but we have to vote, so I won't. Let me just ask you one quick big picture question. It has been suggested by the other side, I think, that Government spending cuts, maybe even cutting some public sector jobs at the State and local level, might do some harm to the economy, might do some harm to the private sector economy. Just give me your view. Does that make sense to you?

Mr. BIGGS. There has actually been a range of studies that have been done by international organizations, like the IMF, the World Bank, the OEC, that have looked at countries that have successfully balanced their budgets. There are some who have tried and failed, some who have tried and succeeded. The countries that tried to balance their budgets and succeeded in reducing deficits and debt did it principally on the spending side, I guess around 85 percent on average spending, only around 15 percent tax increases. And those countries tended to focus on reductions in transfer spending and reductions in what is called the government wage bill, which is the size and pay of the government work force.

One thing that these studies have found, and there is some debate, but the worst case they found was that these sorts of steps tend to be neutral with regard to the economy. Tax increase they founded tended to hurt the growth of the economy. Some studies have found that these steps could even improve economic growth because of the confidence factor they build in. The individuals and businesses and financial markets see the government getting on top of these tough problems. And even if they are long-term solutions, they feel better today and that helps get the economy going again.

Mr. WALSH. Great, thank you. Just one other quick question.

Senator Liljenquist, what is one quick takeaway? What can the rest of the country learn about Utah, if you can bestow one lesson on all of us?

Mr. LILJENQUIST. I think the lesson would be that reality is not negotiable. If you can look forward and see what are bearing as a State, which is what we did on pension problems, it didn't pass the

smell test. We looked at every scenario. And that was 95 percent of the battle, as we went person by person in our legislature, and sat down with them and showed them the data.

We are burying far more risk than we ever dreamed. And I think that is the message, that reality is not negotiable. You have to do something.

Mr. WALSH. Great, thank you.

Mr. Chairman, I yield back.

Mr. MCHENRY. I appreciate the gentleman yielding back. I certainly appreciate the testimony today.

Mr. Kurtter, in particular, thank you for being forthcoming. Your analysis, that is very helpful. We wanted to have that from the credit rating agencies.

I appreciate everybody taking the time to travel to Washington. I know it is not easy to go before a committee like this, but thankfully it was brief in comparison to some other hearings, because we have been called to the floor for votes.

We certainly appreciate your analysis. This is certainly an ongoing series, and we want to have feedback on what is necessary for us to have accurate transparency and disclosure in the marketplace, so that, actually, those participating, those lending money to States, will have the transparency they need to actually make an accurate decision and price risk. That was obviously the center part of this hearing. We certainly appreciate your testimony. We understand there is a challenge out there, the magnitude of which, there has been a little debate. But there is a problem, and we have to tackle that.

Thank you for your testimony. This meeting is now adjourned.

[Whereupon, at 3:11 p.m., the committee was adjourned.]

